No. 75-1221

In the Supreme Court of the United States

OCTOBER TERM, 1975

Supreme Court, U. S.
FILED
FEB 25 1976
MICHAEL RODAK, JR., CLERK

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINIONS BELOW

The recommended decision of the trial judge (App. A, *infra*, pp. 1a-66a) is not officially reported. The opinion of the Court of Claims (App. B, *infra*, pp. 67a-97a) is reported at 524 F.2d 1167.

JURISDICTION

The judgment of the Court of Claims was entered on October 22, 1975 (App. B, *infra*, pp. 67a, 129a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined in Section 801(c).

The question presented is whether an insurance company which bears the ultimate insurance risk on accident and health insurance ceded to it by another company or ceded by it to the other company under reinsurance agreements is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life policies so as to render it ineligible for preferential tax treatment as a life insurance company, or whether, as the Court of Claims held, such reserves are attributable to the other company which temporarily holds the premiums paid in advance on such policies.

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[1] The precise amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (App. B, *infra*, p. 129a).

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112). DEFINITION OF LIFE INSURANCE COMPANY.

(a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves as defined in subsection (c)).

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsur-

ance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801.3 *Definitions.*

* * * * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801-5 *Total reserves.*

* * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * * * *

STATEMENT

Respondent is a wholly-owned subsidiary of Southern Discount Company. At the time of respondent's incorporation in 1957 under the Insurance Code of Arizona, its parent, Southern Discount, was engaged in the consumer finance business in Georgia and several other states. At the time Southern Discount made a loan, its borrowers usually purchased term life and accident and health ("A&H") insurance in order to guarantee the payment of the loan in the event of the borrower's death or disability.

This type of insurance, known as credit life and credit A&H insurance, is generally coextensive in term and coverage with the term and amount of the

loan, and provides for the full payment of the loan in the event of the borrower's death or for the payment of monthly installments on the loan in the event of his disability resulting from accident or sickness. The premiums for such insurance are generally payable by the borrower in advance for the full period of coverage (App. B, *infra*, pp. 68a-69a, 94a-95a).

The Georgia law under which Southern Discount was incorporated prohibited it from issuing credit life and credit A&H insurance. However, it was permitted to act as a sales agent for qualified insurance companies issuing such policies. Prior to its formation of respondent, Southern Discount acted as a sales agent for American Bankers Life Assurance Company, which issued credit life and credit A&H policies to Southern Discount's debtors. Under its arrangement with American Bankers, Southern Discount received a commission of approximately 50 percent of the premiums paid by the policyholders, which was the maximum commission rate allowed by law (App. B, *infra*, p. 69a).

In order to obtain a greater portion of the profits from the credit insurance issued to its borrowers, Southern Discount organized respondent in 1957 for the purpose of underwriting the credit life and credit A&H insurance for its borrowers. Under Georgia law, respondent's initial $38,000 capitalization was insufficient to enable it to act as a direct insurer. However, because of its status as an insurance company chartered in Arizona, respondent was permitted to reinsure policies issued by companies authorized to

issue insurance directly. As a result, on June 28, 1957, respondent entered a reinsurance agreement or treaty ("Treaty I") with American Bankers under which it reinsured all credit life and credit A&H policies thereafter issued by American Bankers to the borrowers from Southern Discount and its subsidiaries (App. B, *infra*, pp. 69a-70a, 95a-99a).

Respondent freely conceded in the court below that it assumed the entire insurance risk under Treaty I on all credit life and credit A&H policies, in exchange for which it received 87½ percent (subsequently increased to 90½ percent) of all premiums collected by American Bankers on such policies. American Bankers collected the premiums in full when it issued the policies. Pursuant to Treaty I, American Bankers each month remitted to respondent its full share of all life insurance premiums received by it during the previous month. However, with respect to the credit A&H premiums, American Bankers remitted to respondent each month only that portion of the premiums collected during the prior month that was ratably allocable to the coverage for the prior month. The remaining portions of respondent's share of A&H premiums were remitted monthly on a pro rata basis over the balance of the term of the policy.

Thus, while respondent received its share of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired. The agreement further provided that respondent would maintain its reserves with respect to the life insurance and that

American Bankers would maintain reserves for "unearned premiums," representing the amount of A&H premiums attributable to the remaining unexpired portions of the terms of the policies (App. B, *infra*, pp. 70a-71a, 110a-117a).

By 1962, respondent's capital increased sufficiently to enable it to qualify as a direct insurer under Georgia and North Carolina law. Thereafter, respondent began to issue directly credit life and credit A&H policies to Southern Discount's borrowers. As a result of this change in respondent's status, on April 18, 1962, American Bankers and respondent entered into a new reinsurance agreement ("Treaty II"). Under Treaty II, respondent became the primary insurer of the credit life and A&H policies issued to Southern Discount's borrowers. American Bankers agreed in form to reinsure 80 percent of the A&H policies issued by respondent. However, American Bankers did not purport to reinsure any of the life insurance issued by respondent (App. B, *infra*, pp. 72a-73a, 99a).

Treaty II provided that respondent was to remit to American Bankers quarterly the premiums collected on the ceded A&H policies, less its own commission of 50 percent. The agreement further provided that American Bankers would return to respondent a quarterly rebate or "experience refund" equal to the total premiums ratably allocable to the insurance coverage for the quarter less the sum of: (1) respondent's 50 percent commission with respect to such "earned" premiums; (2) three percent of gross earned premiums allocable to such quarter;

and (3) the sum of all claims paid during the quarter by American Bankers as reinsurer on such policies. In the event the sum of these three reductions exceeded the earned premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against the experience refund for that quarter (App. B, *infra*, pp. 72a-74a).

As of December 31, 1964, Treaty II was amended to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, in the event it was not absorbed by that time. The effect of this amendment was that American Bankers would be entitled to its 3 percent commission and would incur no insurance loss unless it experienced average claims on these policies exceeding 47 percent of premiums over a period of more than 20 consecutive quarters. Conversely, there were no circumstances under which American Bankers' profit under Treaty II could have exceeded its three percent commission. The loss experience on A&H policies under Treaty II had ranged from 28 to 30 percent of premiums paid. At the time of the 1964 amendment, the loss experience on A&H policies covered by Treaty II was only 18 percent of premiums paid [2] (App. B, *infra*, pp. 72a-74a, 99a-100a, 118a-128a; App. A, *infra*, p. 48a).

During the period 1958-1964, respondent reported

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[2] The trial judge found that the likelihood that loss experience would run so high as to jeopardize American Bankers' commission was so remote as to be negligible, and that the parties knew this to be the fact (App. A, *infra*, p. 48a).

on the annual statements it was required to file with the Arizona and Georgia insurance authorities that it received income from life insurance premiums. Accordingly, it reported the life insurance reserves for such policies prescribed by the appropriate actuarial tables. However, with respect to the A&H policies respondent reinsured with American Bankers under Treaty I, respondent reported as income only the portion of premiums paid to it by American Bankers, which was attributable to the expired portions of the terms of the policies.

Respondent did not report, either as income or as an asset, any of the A&H premiums attributable to the unexpired portions of the terms of the policies, and it reported no reserves with respect to the A&H policies. Similarly, respondent reported no reserves on the A&H policies ceded to American Bankers under Treaty II. American Bankers, on the other hand, maintained unearned premium reserves with respect to the A&H policies reinsured by respondent under Treaty I as well as the A&H policies ceded by respondent under Treaty II.

During 1958-1964, respondent was subjected to a number of examinations by the insurance departments of Arizona, Georgia and other states in which it did business, but its failure to maintain reserves with respect to the A&H coverage under Treaty I or II was never disapproved (App. B, *infra*, pp. 71a-72a, 74a-76a, 101a-102a, 105a-107a).

Respondent filed its federal income tax returns for the years 1958-1964 in accordance with its method of

reporting reserves on the annual statements filed with the various state insurance authorities. Respondent took the position on its tax returns that it qualified for the preferential tax treatment accorded to a "life insurance company" as defined by Section 801(a) of the Internal Revenue Code because its life insurance reserves exceeded 50 percent of its total reserves as it reported on its annual statements. On audit, the Commissioner of Internal Revenue determined that the reserves on the A&H policies under both Treaty I and II were includable in respondent's total reserves. When the A&H reserves were taken into account, respondent failed to qualify as a "life insurance company" under the Section 801(a) definition (App. B, *infra*, pp. 76a-77a, 92a-94a).

In this refund suit brought by respondent in the Court of Claims, the trial judge's recommended decision upheld the Commissioner's determination that respondent was required to include the reserves attributable to the A&H insurance as part of its total reserves so as to disqualify it as a "life insurance company" as defined by Section 801(a) of the Code. The trial judge premised his conclusion on the ground that with respect to both Treaty I and II, respondent was required by Georgia and Arizona law to maintain the reserves attributable to the A&H insurance so that such reserves were includable in respondent's total reserves as "other insurance reserves required by law" under Section 801(c)(3) of the Code. As a result, the trial judge found it unnecessary to decide whether respondent was required to include in

its total reserves the A&H reserves as "unearned premiums" under Section 801(c)(2) of the Code (App. A, *infra*, pp. 14a-23a).

With one judge dissenting, the Court of Claims disagreed with the recommended decision of the trial judge. In accordance with its decision of the same date in *Penn Security Life Insurance Co.* v. *United States*, 524 F.2d 1155, the majority held that the A&H reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because American Bankers was in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under both Treaty I and II (App. B, *infra*, p. 81a). In rejecting the trial judge's conclusion that respondent was required by Georgia and Arizona law to include the A&H reserves in its total reserves, the majority relied upon the fact that respondent's method of reporting its income and reserves did not result in the institution of any action by the Georgia or Arizona insurance authorities (App. B, *infra*, pp. 81a-92a).

The dissenting judge adhered to the views expressed in his dissent in *Penn Security Life Insurance Co.* v. *United States*, *supra* (App. B, *infra*, p. 92a). He argued that the A&H reserves should be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because "[respondent] has arranged to have [such reserves] ostensibly carried for it by others, though in reality it bears the risk of loss itself" (524 F.2d at 1167). In so concluding, the dissenting judge agreed with

the decision of the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466, certiorari denied, 420 U.S. 947, which held, on facts essentially identical to those of Treaty I, that non-inclusion of such reserves "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (524 F.2d at 1167).

REASONS FOR GRANTING THE WRIT

1. As the Court of Claims recognized in its companion decision in *Penn Security Life Insurance Co.* v. *United States*, 524 F.2d 1155, 1161-1162, its holding there and in this case (see App. B, *infra*, p. 81a) directly conflicts with *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, which was followed in *First Railroad & Bank Co. of Ga.* v. *United States*, 514 F.2d 675 (C.A. 5). See also *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). The decision below holding that an insurance company is not required to include in its total reserves those reserves attributable to non-life insurance on which it bears the ultimate insurance risk so that it may qualify for the preferential income tax treatment accorded to a "life insurance company" as defined in Section 801(a) of the Internal Revenue Code of 1954, is therefore in conflict with those of two courts of appeals. The issue has been and continues to be widely litigated, and resolution of the conflict by this Court is essential in order that there be a uniform national rule.

Moreover, the effect of the decision below upon the revenue is substantial. We are advised by the Internal Revenue Service that there are at present pending administratively 90 cases involving the issue with more than $28 million of taxes at stake. Since any insurance company may sue for a refund in the Court of Claims and invoke the authority of its decision in this case, the fiscal significance of the decision below potentially encompasses every pending case involving the issue. A decision with such far reaching impact upon the federal revenues involving the basic statutory definition of a "life insurance company" calls for review by this Court.

2. a. Under the Internal Revenue Code of 1954, life insurance companies enjoy tax treatment which is markedly more favorable than that of other types of insurance companies. Pursuant to Section 802 of the Code, a life insurance company is generally subject to a current tax only on (1) a prescribed portion of its investment income (Section 804); and (2) one-half of the amount by which its "gain from operations" (Section 809) exceeds its "taxable investment income."[3] On the other hand, other types of stock insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are gen-

[3] The structure and operation of the present statutory system for the taxation of life insurance companies are summarized in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235-238, and *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 844-846 (C.A. 4), certiorari denied, 396 U.S. 828.

erally taxable on their total annual net income. See Sections 831 and 832 of the Code.

Like respondent, many insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. Accordingly, as early as Section 242 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 261, Congress provided for an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose predominant business was the assumption of life insurance risks.[4] See, *e.g.*, *National Protective Ins. Co.* v. *Commissioner*, 128 F.2d 948, 950 (C.A. 8), certiorari denied, 317 U.S. 655; *New World Life Insurance Co.* v. *United States*, 26 F. Supp. 444, 461 (Ct. Cl.), affirmed on another issue, 311 U.S. 620; *Commissioner* v. *Monarch Life Ins. Co.*, 114 F.2d 314, 324-325 (C.A. 1).

The current statutory test is set forth in Section 801(a) of the 1954 Code, *supra*, p. 3, which defines

[4] As Dr. T. S. Adams of the Treasury Department explained to the Senate Finance Committee in 1921 (Hearings on H.R. 8245, Internal Revenue, before the Senate Committee on Finance, 67th Cong., 1st Sess. 85 (1921))—

> Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 percent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company.

a "life insurance company" as an insurance company whose life insurance reserves plus its unearned premiums and unpaid losses on noncancellable life, health or accident policies comprise more than 50 percent of its total reserves. Section 801(c) in turn defines the term "total reserves" as consisting of: (1) life insurance reserves; (2) unearned premiums and unpaid losses not included in life insurance reserves; and (3) all other insurance reserves required by law.

b. The question presented in this case concerns respondent's eligibility as a "life insurance company" under Section 801(a) of the Code. During the taxable years at issue, respondent bore the ultimate insurance risk with respect to both life and non-life (A&H—accident and health) insurance under two successive reinsurance agreements (Treaty I and II) with another insurance company, American Bankers Life Assurance Company. The resolution of the question presented turns on whether the reserves attributable to the non-life policies are includable in respondent's total reserves or in American Bankers' total reserves. As the court below stated: "If those reserves are includable in [respondent's] total reserves, it concededly does not pass the 50 percent test of Section 801. If, as [respondent] says, they are chargeable to American Bankers rather than to itself, it does" (App. B, *infra*, p. 79a).[5]

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[5] Respondent does not contend that the accident and health policies were "noncancellable life, health, or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Under the accident and health coverage in question, the insured did not have a guaranteed option to renew on the expiration of the initial term. Thus, it was not "noncancellable" within the meaning of the statute. See *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480-482.

Here, the Court of Claims held that the A&H reserves were includable in American Bankers' total reserves under both reinsurance transactions to which respondent was a party. We submit, however, that a careful analysis of the economic substance of the Treaty I and II arrangements, which are typical of those used in the industry, decisively establishes that the A&H reserves under both treaties are includable in respondent's total reserves as "unearned premiums" under Section 801(c)(2).

Under Treaty I, respondent reinsured all of the credit life and A&H policies issued by American Bankers in exchange for 90½ percent of the premiums collected by American Bankers. But the court below recognized with respect to Treaty I that all life and A&H policies first issued by American Bankers "were to be fully reinsured with [respondent] which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A&H as well as life" (App. B, *infra*, p. 70a). Since respondent and not American Bankers assumed the full risk under the A&H policies, those policies reflected its insurance business and not that of American Bankers, whose role was limited to that of a commission agent.

Simply put, the insurance reserves necessarily follow the insurance risk, as evidenced by respondent's retention of 90½ percent of the A&H premiums to meet the claims under the policies. Thus, the reserves necessary to meet the A&H insurance risk were properly includable in respondent's insurance reserves. Indeed, to conclude, as the Court of Claims did, that the A&H reserves were part of American Bankers' total reserves because that company temporarily held the "unearned" portions of the A&H premiums before ratably paying them to respondent is to exalt the form of the transaction over its economic substance by ignoring the fact that the final destination of the A&H premiums was respondent and not American Bankers. Cf. *Superior Life Insurance Co.* v. *United States, supra*, 462 F.2d at 950.

The fundamental error of the Court of Claims in holding that the A&H reserves were attributable to American Bankers was its assumption that that company held "unearned premiums" of the A&H policies in the sense that term is used in Section 801(c)(2). However, the term "unearned premiums" in the statute connotes an insurance company's maintenance of a reserve from premiums to meet the risk of claims it has assumed. But here American Bankers did not hold "unearned premiums" to meet any insurance risk it had assumed. To the contrary, it was holding such premiums under an obligation to pay them over to respondent, which had assumed the risk under the A&H policies throughout the term of their coverage.

Under these circumstances, American Bankers can-

not be deemed to possess a reserve under the A&H policies simply because it was temporarily holding the A&H premiums on behalf of respondent. As the Seventh Circuit stated in its contrary decision in *Economy Finance Corp.* v. *United States, supra*, in characterizing the role of a company analogous to American Bankers in an arrangement virtually identical to Treaty I: "[it] performed a banking and clearing house function and not an insurance function" (501 F.2d at 478). Like the ceding company in *Economy Finance*, American Bankers was exposed to no insurance risk under Treaty I. Pursuant to that arrangement, American Bankers cannot be deemed to have any insurance reserves. The A&H reserves must therefore be included in respondent's total reserves under Section 801(c)(2).

The foregoing observations are equally applicable to Treaty II. Under that more elaborate but economically equivalent arrangement, respondent directly issued the A&H policies and American Bankers purported to reinsure them. But in addition to respondent's initial retention of 50 percent of the A&H premiums as a commission, American Bankers was required to pay over to respondent 47 percent of the premiums after deduction of any claims paid. Moreover, pursuant to a loss carryover mechanism under Treaty II, American Bankers could incur no insurance loss unless it experienced average claims exceeding 47 percent of A&H premiums for more than five consecutive years. Since the loss experience under Treaty II ranged from 18 to 30 percent

of A&H premiums, the trial judge was amply justified in finding that the likelihood that American Bankers would be exposed to any insurance risk was so remote as to be negligible, and that the parties knew that to be the fact (App. A, *infra*, p. 48a).

In sum, as in the case of Treaty I, American Bankers' role under Treaty II did not constitute an insurance function but was limited to a banking and clearing house function of receiving premiums and disbursing payment for claims in exchange for a commission equal to no more than three percent of the premiums.[6] Thus, under Treaty II, American Bankers assumed no risk of insurance. That risk remained with respondent, which kept 97 percent of the A&H premiums to meet the claims under the policies.

Respondent can therefore no more avoid inclusion of the A&H reserves in its total reserves under Treaty II than it can under Treaty I. As the Fifth Circuit in *First Railroad & Bank Co. of Ga.* v. *United States, supra*, 514 F.2d at 677, correctly concluded in its contrary holding with respect to an arrangement identical to Treaty II: "Reinsurer under the arrangement did not bear any risks except the outside possibility of insolvency of Insurer. We hold therefore there was no substance to the agreement as reinsurance" (footnote omitted). The lack of substance to Treaty II as reinsurance likewise renders

[6] The court below acknowledged as much in stating: "* * * there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein" (App. B, *infra*, p. 74a).

respondent ineligible for "life insurance company" status during the years that latter arrangement was in force.[7]

[7] The fact that the Court of Claims also concluded (App. B, *infra*, pp. 81a-91a) that respondent was not required under Georgia or Arizona law to establish a reserve for the A&H policies does not weaken our argument that the economic reality of the reinsurance transactions is controlling for federal tax purposes under Section 801(c)(2). Indeed, in the life insurance area, this Court has repeatedly indicated that state insurance statutes or administrative practices do not determine the question whether certain reserves should be taken into account for federal tax purposes, even though they were required under state law. See, *e.g.*, *McCoach* v. *Insurance Co. of North America*, 244 U.S. 585, 589 (reserve for unpaid losses); *United States* v. *Boston Insurance Co.*, 269 U.S. 197 (loss claim reserves); *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 119 (reserve for unreported losses); *Helvering* v. *Illinois Ins. Co.*, 299 U.S. 88, 90-91 (reserve to meet obligation to provide a tontine fund). In the present context, "[t]he fact that the state insurance authorities required or permitted [American Bankers] to hold the reserve for solvency purposes does not answer the question of whose business the reserves measure." *Economy Finance Corp.* v. *United States, supra*, 501 F.2d at 478-479. As the Fifth Circuit similarly observed in *First Railroad & Bank Co. of Ga.* v. *United States, supra*, 514 F.2d at 677 n. 8: "The fact that the state insurance authorities permitted the 'reserves' to be handled as done by Insurer and Reinsurer cannot overcome these economic realities."

At all events, we submit that the Court of Claims erred in concluding that Georgia and Arizona law did not require respondent to establish a reserve for the A&H policies under both Treaty I and II. While the Court of Claims did not appear to refute the trial judge's analysis of the applicable state statutes (App. A, *infra*, pp. 15a-16a, 20a-23a), it premised its conclusion on the fact that neither the Georgia nor Arizona authorities took any action against respondent's

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1976.

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failure to establish such a reserve for state reporting purposes. But the Georgia chief examiner testified that respondent's failure to report in its annual statement any unearned premium reserve was permitted "unwittingly" by Georgia (Tr. 380) and was contrary to that state's policy (Tr. 335-337, 341-342, 353-359, 370, 380, 382, 385, 409-413). Similarly, the Arizona examiner who had conducted respondent's triennial examination for that state for 1963 also testified that it should have been required to maintain the unearned premium reserves under Treaty II, but had been permitted to take credit for the reserves because it was the first time that the Arizona insurance commissioner had encountered that situation (Tr. 423, 425-429).

Thus, the A&H reserves under both Treaty I and II would be includable in respondent's total reserves on the independent alternative ground that they were "other insurance reserves required by law" under Section 801(c)(3) of the Code. See also Treasury Regulations, Section 1.801-5(b).

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS
TRIAL DIVISION

No. 463-70

(Filed Dec. 13, 1974)

CONSUMER LIFE INSURANCE COMPANY

v.

THE UNITED STATES

E. Michael Masinter, attorney of record, for plaintiff. *James H. Landon* and *Hansell, Post, Brandon & Dorsey*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Gilbert E. Andrews*, of counsel.

OPINION *

WILLI, *Trial Judge*: This is a single issue tax refund suit that arises out of a small loan company's entry into the insurance business through a wholly owned subsidiary that it formed especially for that purpose. The question is whether that sub-

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* The trial judge's recommended decision and conclusion of law are submitted in accordance with Rule 134(h).

sidiary, the plaintiff in this proceeding, qualified for the discrete tax treatment accorded a "life insurance company" by the Internal Revenue Code.

The facts, which are basically uncontested, are fully detailed in the findings of fact accompanying this opinion and will be repeated herein only to the extent necessary to an understanding of the result reached.

In 1957 Southern Discount Company (Southern), a Georgia corporation, was operating a well established and successful consumer finance business. Its customer-borrowers typically purchased term life and accident and health (A & H) insurance at the time that they obtained their loans. The premium charge for the entire coverage involved was thereupon paid in full. The customers bought this protection, coextensive in both time and amount with the curtailment requirements of their borrowings, to provide a means of automatically servicing their debts to Southern in case of death or disability prior to full repayment. Georgia law prohibited Southern, as a loan company, from acting as an insurance underwriter with respect to such coverages. It was not forbidden, however, from functioning as a sales agent for insurance underwritten by a carrier duly qualified to conduct an insurance business in Georgia. American Bankers Life Insurance Company (American Bankers), a Florida corporation, was such a carrier.

Until 1957 Southern acted as a commission sales agent for American Bankers in respect to life and A & H insurance issued by the latter to Southern's

borrowers. Under this arrangement, Southern received the maximum commission rate allowed by law; amounting to approximately 50 percent of the policyholder premiums. Despite the attractiveness of that return, for which it apparently had to do little more than place American Bankers' policies with its own borrowers, Southern concluded that it could reap even greater profits from this source if it could participate as an underwriter rather than just a sales agent. It was that determination that prompted Southern to form the plaintiff as a wholly owned subsidiary.

Southern surveyed state law to locate the jurisdiction that had the most modest capitalization requirements for a licensed insurer and found that it was Arizona. Plaintiff was organized July 1, 1957 as an insurance company under an Arizona charter with an initial balance of invested capital and paid-in surplus of only $38,000. These resources were not sufficient to permit it to qualify as a direct insurer under Georgia law. It could, however, use its Arizona charter authority to operate as a reinsurer of Georgia and North Carolina coverages written by American Bankers—a duly authorized insurer in both of those states. American Bankers was willing to enter into a reinsurance treaty arrangement with plaintiff, under which it surrendered substantially all underwriting profit in return for a relatively minimal fixed fee, because it knew that if it refused, Southern would have no difficulty in replacing it with another qualified carrier. Thus,

its alternative was outright exclusion from the insurance business generated by Southern's borrowers. Thereupon, on June 28, 1957, American Bankers entered into the first of two consecutive insurance treaties (Treaty I and Treaty II, respectively), with the plaintiff.

Two premises are assumed for purposes of this decision; first, that insofar as germane to this case the relationship between plaintiff and American Bankers was arm's-length and, second, that while tax considerations no doubt were an influencing factor, there were business considerations underlying plaintiff's participation in the arrangements with American Bankers that are the subject of this suit. This is particularly true of the first of the two treaties to be discussed.

Under Treaty I, the entire text of which is set forth in finding 10, *infra*, all life and A & H policies issued by American Bankers to debtors of plaintiff's affiliates (including the parent, Southern), on and after July 1, 1957 were to be fully reinsured with plaintiff which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A & H as well as life. As compensation for its reinsurance function, plaintiff was to receive 87½ percent (later increased to 90½ percent) of all premiums collected by American Bankers from the policyholders. The timing of these payments by American Bankers to plaintiff differed, however, as between life and A & H, although the agreement required monthly remittances in each in-

stance. As already noted, American Bankers collected all premiums in full at the inception of coverage. The Treaty stipulated that as to life policies, American Bankers was, at the end of each month, to pay plaintiff its entire share of all life premiums collected from policyholders during that month. As to A & H, however, American Bankers was to pay plaintiff only the portion of its total share of premium receipts during that month that was ratably allocable to that month's coverage; the agreement being to pay over the remainder monthly on a pro rata basis spread over the balance of the coverage period. Thus, in respect to A & H, plaintiff never actually held any premium dollars attributable to a future period of coverage and risk exposure.

Finally, Treaty I provided for termination by either party upon thirty days' written notice to the other. Termination was to be wholly prospective, the relevant clause specifying: "Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective." Finding 10, *infra*.

As required by state law, plaintiff filed annual reports of its activities under Treaty I with the insurance regulatory authorities in Arizona and Georgia. On those reports it characterized its life and A & H dealings differently. It did so by reporting both premium income and related reserves solely on the basis of actual dollar receipts for the year involved. This meant that for the life coverages it declared as premium income its entire percentage

share of the premiums paid by policyholders during that year. Consonantly, it reported the full tabular reserve for all of such policies. As to A & H, however, it limited reported premium income to the annual aggregate of the incremental payments that had been received monthly from American Bankers. Moreover, it showed nothing on the asset side of the report representing the premiums on existing A & H policies that it was entitled under the Treaty to receive in the future. With premium income and asset balances thus restricted, plaintiff reported no reserves whatever in respect to the A & H coverages that it reinsured under Treaty I. As to those coverages, American Bankers included on its own annual reports an unearned premium reserve based on the amount of A & H premiums collected from policyholders but not yet paid over to the plaintiff. Finding 15, *infra*. Neither the Georgia nor the Arizona regulatory authorities ever challenged or disapproved the method by which plaintiff reported its A & H reinsurance activities under Treaty I. Finding 16, *infra*.

By 1962 plaintiff had accumulated enough earnings from operations under Treaty I to enable it to qualify as a direct insurer under Georgia and North Carolina law. It thereupon applied for and received such authority from the State of Georgia. From then on plaintiff operated as the issuing company on all life and A & H policies sold to the loan customers of Southern and its affiliates. Treaty I, in which plaintiff's role was solely that of a reinsurer,

was consequently no longer suited to its purposes. Accordingly, effective March 1, 1962, plaintiff and American Bankers entered into a new insurance treaty under which their roles were reversed; plaintiff functioning as the issuing or ceding carrier and American Bankers denominated the "reinsurer".

Treaty II, the text of which is set forth in full at finding 17, *infra*, applied only to A & H insurance; plaintiff having determined to underwrite all future life insurance by itself. The Treaty provided that plaintiff, as the issuing or ceding company, would reinsure 80 percent of all future A & H policies with American Bankers. To that extent, plaintiff was to pay over to American Bankers on a quarterly basis all of the premiums collected from policyholders, American Bankers to return 50 percent of such amounts to the plaintiff as commissions. The Treaty contained a clause, entitled Experience Refunds, establishing a quarterly rebate due plaintiff in the amount of the total premium dollars ratably allocable to the expired portion of the term of policies for which such premiums had been collected, less the following deductions: (a) the amount of commissions paid plaintiff that was proportionate to the expired portion of the term of policies on which such commissions had been paid; (b) 3 percent of the earned premium dollars previously described; and (c) the sum of all claim payments made to plaintiff during the quarter by American Bankers as reinsurer. For all practical purposes, this clause served to fix American Bankers' stake in the undertaking

at a flat 3 percent of the premium dollars that it initially received from the plaintiff. Only if loss experience under the reinsured coverages exceed 97 percent of premiums would American Bankers' 3 percent return be encroached. Moreover, such a pattern of adverse experience would have had to persist for the ensuing twenty consecutive quarters before such an encroachment became permanent. Loss experience on A & H policies under Treaty I had ranged from 28 to 30 percent. Finally, there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein.

On its annual reports to the state regulatory authorities covering 1962 and subsequent years, plaintiff declared no reserves relative to that portion of the A & H policies covered by the reinsurance language of Treaty II. Again, no state regulatory authority took exception to this aspect of plaintiff's reports.

For each of the years 1958 through 1964 plaintiff computed its federal income tax liabilities and filed its returns on the premise that it was taxable as a "life insurance company" within the meaning of that term as defined by Section 801 of the Internal Revenue Code of 1954. On audit, the Revenue Service determined that plaintiff did not qualify as a life insurance company entitled to the preferential tax treatment accorded such an entity [1] and assessed de-

[1] *Economy Finance Corp.* v. *United States*, 501 F.2d 466, 474 (7th Cir. 1974), presents a succinct and lucid exposition of the policy considerations justifying special tax treatment for life insurance companies.

ficiencies accordingly (except for 1961 in which additional liability was fully expunged by other adjustments not in dispute). Plaintiff paid the assessments and upon formal disallowance of its seasonably filed claims for refund, brought this action, in which the sole question for decision is that concerning plaintiff's qualification as a life insurance company for federal tax purposes in the years 1958, 1959, 1960, 1962, 1963 and 1964.

As pertinent here, Section 801 defines a life insurance company as follows:

> SEC. 801 [as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.
>
> (a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * *

Life insurance company status, it is seen, is made to depend solely on the character and composition of an insurance company's reserves. An insurance company merits life insurance company tax treatment if its life reserves amount to half or more of its total insurance reserves. Section 801(c) expressly directs that total reserves, the denominator portion of the fractional test, shall include three separate categories: (1) life reserves; (2) reserves for unearned premiums and for certain unpaid losses (the latter element not being involved in this suit); and (3) all other reserves required by law.[2]

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[2] The last-mentioned category has been traditionally and centrally implicated in the federal taxation of insurance companies. *See Brown* v. *Helvering*, 291 U.S. 192, 201 (1934), and cases cited therein.

Sections 1.801-3(e) and 1.801-5(b) of the Treasury Regulations on Income Tax (1954), endorsed by both parties to the present controversy, define unearned premium reserves and reserves required by law, respectively, as follows:

Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * *

Reserves required by law defined. For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

In this case there is no disagreement as to either the fact or the particular amount of plaintiff's life insurance reserves for each of the years in suit. Its qualification depends entirely on the question of its chargeability with reserves incident to the A & H policies to which it was a party under Treaties I and II; there being no dispute that reserves must be maintained by someone in respect to those policies.

If those reserves are includable in plaintiff's total reserves, it concededly does not pass the 50-percent test of Section 801. If, as plaintiff says, they are chargeable to American Bankers rather than to itself, it does.

The cornerstone of plaintiff's position herein is its unduly restricted conception of the reserve criteria of Section 801. In effect, its approach reads out of the statute that portion of it [Section 801(c)(3)] specifying that "total reserves", for purposes of the fractional test, shall include "all other insurance reserves required by law". It consequently characterizes the issue to be decided solely in terms of whether it was obliged to maintain a reserve for unearned premiums, within the meaning of Section 801 (c)(2), in respect to the A & H policies covered by two Treaties.[3] In fairness, it should be noted that in earlier litigation with others, litigation that produced precedents that plaintiff urges should control this case, the Government's apprehension of the issue was apparently as limited as plaintiff says that it should be here. That background could understandably have encouraged plaintiff to adopt its present litigating perspective. Nonetheless, while it is

[3] On brief, plaintiff posits the question presented, as follows:

> May the Commissioner of Internal Revenue require plaintiff to include, for purposes of measuring plaintiff's reserves for purposes of qualification as a life insurance company, under the Internal Revenue Code, premiums, or reserves based on those premiums, held by an unrelated party pursuant to the terms of reinsurance treaties entered into for valid business reasons?

true that the Government's presentation herein is largely addressed to the issue as framed by the plaintiff, the presentation does include the supplementary contention that plaintiff was chargeable with A & H reserves, whether or not cast in the mold of unearned premiums, because such were required of it by state law.

To dispel the notion that it was required to maintain A & H reserves of a type comprehended by Section 801, plaintiff relies on (1) the language of the two insurance treaties under which it operated with American Bankers; (2) the testimony of a well-traveled actuarial expert, Arthur Crooks Eddy; (3) the fact that the state insurance regulatory personnel tacitly approved plaintiff's annual report forms showing no A & H reserves; and (4) the trial court's opinion in *Economy Finance Corp.* v. *United States*, 30 AFTR 2d 72-5446 (S.D. Ind. July 25, 1972), and this court's trial judge's opinion in *Penn Security Life Ins. Co.* v. *United States* (Ct. Cl. No. 109-68, decided March 2, 1973).

Simpliciter, the argument is that plaintiff was chargeable with no A & H unearned premium reserves because under both of the Treaties it received premium dollars only after the period of exposure to which those dollars related had expired. Accordingly, plaintiff says, since all the premiums that it received were, in point of time, already "earned" when it got them, there was no occasion for it to maintain a reserve for "unearned" premiums. Testifying as plaintiff's expert, Mr. Eddy

repeatedly opined that this feature of the Treaties, governing custody of prepaid premium dollars, was dispositive of the participants' respective reserve obligations, *i.e.*, that since it was American Bankers that physically held all of the A & H premium dollars allocable to the unexpired portion of the terms of the underlying policies, it was American Bankers, not plaintiff that was obligated to carry the reserves for those policies. In this regard, his testimony was the same as it apparently had been in *Economy Finance, supra,* and *Penn Security, supra.* At least in the latter case, if not the former as well, the relevant particulars of the factual situations involved were virtually identical to those presented by Treaty I. Certainly in the present case and seemingly in neither of his appearances in the earlier ones did Mr. Eddy undertake to canvass or discuss the particular provisions of applicable state law governing an insurer's reserve obligations—this even though he was testifying throughout in the context of a revenue statute that in part expressly relates such obligations to the requirements of state law.

It is unnecessary to decide specifically whether plaintiff was chargeable with any A & H unearned premium reserves covered by Section 801(c)(2) because however that might be, it was clearly required by state law to maintain reserves, cognizable by Section 801(c)(3), for the A & H policies to which it was a party under each of the Treaties.

As earlier noted, plaintiff freely acknowledges that it ultimately bore the entire insurance risk under Treaty I.

Section 56-908 of the Georgia Code Annotated, reproduced in full in finding 26, *infra,* expressly requires that: "For all accident and sickness policies the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under such policies * * *." To the degree that risk exposure is the hallmark of an insurer, this provision squarely imposes a reserve obligation on plaintiff with respect to the A & H liabilities concededly assumed by it under Treaty I. While there are other and more compelling statutory reserve requirements, it may be noted that both Section 56-906 of the Georgia Code Annotated, finding 26, *infra,* and Section 20-506 of the Arizona Revised Statutes, finding 27, *infra,* employing generally similar language, require an "insurer" of coverages such as A & H maintain an unearned premium reserve in an indicated amount. It would seem that as the bearer of the ultimate policy risk exposure under Treaty I, plaintiff was an "insurer" within the contemplation of those provisions and was not the less so simply because it voluntarily elected to accept premiums piecemeal rather than in gross at the inception of coverage.

Finally, and whatever the case as to unearned premium reserves, an additional and important feature of state law applicable here plainly required

plaintiff to maintain A & H reserves in respect to Treaty I operations.

The express language of Treaty I, including that dealing with termination, vested plaintiff with an absolute right to receive, albeit in incremental installments, its full share (ultimately 90.5 percent) of all premiums collected from A & H policyholders whose coverages once became subject to the Treaty. Findings 10 and 13, *infra*. Mr. Eddy acknowledged at the trial that an insurer legally entitled to receive premiums in the future with respect to existing coverages is obliged to reflect such a right as an asset, in the nature of a receivable, on its reports to cognizant state regulatory authorities. He further recognized that such an asset gives rise to a concomitant liability in the nature of a reserve relating to the underlying exposure assumed in conjunction with and in consideration of the right to receive premiums in the future on the subject coverages. The laws of both Georgia and Arizona, findings 26 and 27, *infra*, bear out Mr. Eddy's testimony in this respect. Consequently, on the basis of the unambiguous language of Treaty I and the uncontradicted testimony of plaintiff's expert, both considered in the light of applicable state law, plaintiff was definitely obliged to maintain reserves in respect to the A & H policies to which it was a party under Treaty I. This is so whether or not such reserves are conceptually accommodated by Code Section 801(c)(2), speaking to "unearned premiums".

Plaintiff's reliance on *Penn Security Life Ins. Co.* v. *United States*, *supra*, as commending a contrary result is not well-taken.

An examination of the pertinent findings of fact in that case discloses that the plaintiff there, a Missouri corporation, was situated in circumstances factually identical to the present plaintiff operating under Treaty I. Finding 28, *infra*. There, as here, the plaintiff, as a reinsurer, was committed by express treaty provision to assumption of the entire insurance risk on all A & H policies subject to it and was, in turn, guaranteed the right to receive, on a deferred, incremental basis, its entire share of premiums collected from policyholders on A & H coverages in force at any time that the treaty was terminated. In short, the plaintiff in *Penn Security* had the same enforceable right to receive premium monies in the future as did the present plaintiff under Treaty I. Although Arthur Crooks Eddy testified as the plaintiff's expert in *Penn Security*, *supra*, his testimony did not include the acknowledgment that it did in the instant case, *viz*, that an insurer with an enforceable right to receive premiums in the future is obliged by state law to show the value of that right on the asset side of its annual report and to concurrently establish a related reserve reflecting the future insurance risk exposure in consideration of which it is entitled to receive such premiums.

Additionally, the court, in *Penn Security*, *supra*, was apparently not given the benefit, by Mr. Eddy or anyone else, of an exposition of the provisions

of state law affecting insurers' reserve responsibilities. Thus, the court found (finding 28, *infra*):

> * * * [*T*]*he mere fact that the ceding companies obtained reinsurance from plaintiff* under these treaties *did not affect their responsibility,* under state law or under actuarial principles, *to set up an unearned premium reserve* to reflect the unearned premiums actually held by those companies *on policies covered by reinsurance* treaties with plaintiff. * * * [Emphasis added]

VERNON'S ANNOTATED MISSOURI STATUTES provide in relevant part (finding 30, *infra*):

> 376.410. *Insurance companies to maintain reserves—exemptions*
>
> Except as provided in subdivision (6) of this section, all companies organized under the laws of this state, and engaged in writing policies of accident or health insurance, or combination policies of accident and health insurance, and all other companies transacting such kinds of business in this state, shall maintain reserves thereon in accordance with the following requirements:
>
> * * * *
>
> (4) In the calculation of reserves required to be maintained under this section, *proper credit shall be allowed for reinsurance in other companies* licensed to do business in this state; [Emphasis added]
>
> * * * *

For the various foregoing reasons, *Penn Security, supra,* really furnishes no support for the result urged by plaintiff under Treaty I.

The other precedent on which plaintiff relies, *Economy Finance Corp.* v. *United States,* 30 AFTR 2d 72-5446 (S.D. Ind. 1972), involved the reserve responsibilities of an A & H reinsurer that received premium remittances from a ceding carrier on an "as earned" basis similar to that involved here. The comparability to Treaty I of the treaty there involved is not nearly so clear as in the *Penn Security* situation.

It suffices for present purposes to note that the trial court's decision was reversed on appeal, albeit by a divided court. *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974). The dissent in that case[4] suggests that the majority reached its conclusion by applying a qualification test not authorized by Section 801 of the Revenue Code. Whatever the case in that regard, clarity requires an affirmative acknowledgment that the issue apprehended for purposes of the present opinion differs from that addressed by the majority in *Economy Finance, supra,* to wit (at 471):

> * * * The issue raised by the government is *not whether taxpayers should actually have established H & A reserves* but how such reserves should be considered for the limited purpose of determining taxpayers' qualifying ratio. This is not a question of form over substance but rather

[4] 501 F.2d at 483-86.

one of the proper characterization of the substance. [Emphasis added]

The issue decided herein is precisely that of whether the plaintiff, operating under Treaty I, *should actually have established A & H reserves.* Section 1.801-5(b) of the applicable Treasury Regulations, *supra*, permits no lesser standard where the inquiry is, as here, whether a reserve is comprehended by Code Section 801(c)(3). The evidence presented in this record, including the testimony of plaintiff's own expert, conclusively demonstrates that more than one facet of applicable state law required that *plaintiff should actually have done so.* To invalidate that conclusion requires much more than an implication based on the bare fact of the state regulatory authorities' failure to affirmatively challenge plaintiff's omission of A & H reserves from its annual reports covering Treaty I years. Exculpatory possibilities accounting for such unexplained inaction are limited only by the fertility of one's imagination. Moreover, in this instance the Treasury Regulation [5] defining "reserves required by law" for purposes of Code Section 801—a regulation to which plaintiff unreservedly subscribes on brief—notably casts state statutory provisions and administrative practice relative thereto in disjunctive, not conjunctive terms.

That plaintiff was chargeable by state law with A & H reserves under its Treaty II activities follows from a much simpler analysis than required for

[5] Treasury Regulations, Section 1.801-5(b).

Treaty I. Those A & H policies, unlike the coverages subject to the earlier Treaty, were issued by the plaintiff to the individual policyholders from whom it concurrently collected the full amount of the underlying premiums. It was, then, in the first instance the "insurer" of those policies, as that term is used in the relevant Georgia insurance statutes. Finding 26, *infra.* As such, it was subject at the outset to the reserve obligations imposed on insurers by Sections 56-905 and 56-908 of the Georgia Code Annotated, *supra.* Plaintiff's initial status as the insurer of all A & H policies issued by it was simply unaffected by Treaty II.

The essence of insurance is risk-shifting and risk distribution. *Helvering* v. *LeGierse*, 312 U.S. 531, 539 (1941). Reinsurance, which has a settled and traditionally understood meaning,[6] is insurance by the first insurer of the whole or some part of his interest in the risk created by his original contract of insurance. Treaty II effected no reinsurance because under it American Bankers assumed no part of the risk represented by the A & H policies issued by the plaintiff.

By virtue of the provisions of Articles I, II, IV and XIII, and particularly those of Article VI dealing with Experience Refunds, plaintiff retained the entire insurance risk under all of the A & H policies covered by Treaty II. Finding 17, *infra.* Because

[6] *Allemannia Fire Ins. Co.* v. *Firemen's Ins. Co.*, 209 U.S. 326 (1908).

of Article VI, American Bankers' pecuniary interest in Treaty II, aside from an investment return on premiums temporarily held, was fixed at 3 percent of the A & H premiums covered by the Treaty, without regard to loss experience. Only if losses under the subject policies exceeded 97 percent of premium income could American Bankers' receipt of its 3 percent participation be delayed to a subsequent quarterly period. The likelihood that loss experience would run as high as 97 percent was so remote as to be negligible and the parties knew this in advance on the basis of extensive prior experience with similar coverages. Finding 20, *infra*. Under these circumstances, American Bankers had no insurance role under Treaty II. Instead, it functioned essentially as a fixed-fee supplier of clerical services and a temporary, albeit beneficial custodian of premium monies that it was contractually obligated to return to the plaintiff on what amounted to a predetermined schedule. Its returns for these undertakings were substantially unaffected by the insurance risk appurtenant to the policies with which it was concerned. That the plaintiff voluntarily elected to relinquish control over A & H premiums, subject to a contractual right to fully regain them in incremental installments over a period of time, made it no less the real insurer of the risk represented by the policies to which those premiums pertained. The state authorities' acceptance of plaintiff's Treaty II-era annual reports showing no A & H reserves for the exposures on which American Bankers was

a nominal reinsurer is of no greater substantive consequence than their similar conduct in respect to Treaty I reports, as previously discussed.

Since plaintiff was required by law to maintain reserves with respect to the A & H policies covered by both Treaties I and II, it failed the fractional reserve test of Section 801 for tax treatment as a life insurance company. It therefore must be denied recovery.

FINDINGS OF FACT

1. Plaintiff was incorporated in Arizona on June 26, 1957 as a stock insurance company under the insurance code of that state. Its Articles of Incorporation authorized the following activities:

> (a) To insure, in its own proper and corporate name, the lives of persons and all insurance appertaining thereto, including, but not limiting the generality of the foregoing: term, industrial, retirement income, ordinary, modified, single premium, limited payment, group and all other types and forms of contracts of insurance upon or relating to the lives of persons in connection with the extension of credit to such persons.
>
> (b) To reinsure all or a part of any risk, class of risks, or all of the risks of the Company with any other insurance company or companies, and to accept such reinsurance from any other insurance company or companies, as allowed by law.

2. Plaintiff's outstanding stock has been owned throughout by Southern Discount Company (South-

ern) which, at all times pertinent hereto, was a Georgia corporation licensed under the consumer finance laws of the states in which it operated, to conduct a consumer finance business.

3. Credit life and accident and health insurance are sold in connection with a loan of money or an installment sale of tangible personal property. Credit life insurance, generally defined, is term insurance on the lives of debtors, with their creditors as beneficiaries, in amounts at least sufficient to discharge their indebtedness in case of death. The life coverage is frequently combined with accident and health coverage. The latter type pays the debtor's monthly installments during the period within the policy term in which he is totally disabled (*i.e.*, unable to work) because of accident or sickness, provided that the disability lasts beyond a minimum or "waiting" period. Coverage may be conditioned upon the permanent as well as total disability of the debtor. When life and accident and health coverage are provided in one contract, the respective premiums are separately stated. Premiums under both types of policy are collected in full from the insured at the inception of coverage.

4. Southern formed plaintiff because under the laws of Georgia and those of the other states in which it operated it was prohibited from acting as an insurance company. It was permitted, however, to act as an agent for authorized insurance companies and prior to plaintiff's formation it did so on behalf of various such companies, principally Amer-

ican Bankers Life Insurance Company (American Bankers), in respect to life and accident and health (A & H) policies sold to Southern's borrowers.

5. Acting as "sales agent" Southern received a commission of forty percent of premiums in North Carolina and fifty percent of premiums in Georgia, the maxima permitted by the laws of those jurisdictions. It was in order to obtain a greater proportion of the total profit on insurance sold to its borrowers that Southern formed the plaintiff. American Bankers was willing to permit Southern, through its plaintiff subsidiary, to realize a greater portion of the total profit obtained from insuring its debtors because it (American Bankers) realized that if it did not participate in an arrangement providing that result its alternative was total exclusion from the undertaking with a consequent loss of any profit participation at all. In short, American Bankers preferred half a loaf to nothing at all.

6. American Bankers is an insurance company licensed to engage in the life and disability insurance business under the laws of the State of Florida.

7. Other than as a party to certain treaties described more particularly below, American Bankers was totally unrelated to plaintiff at its inception and has remained an unrelated company except for its ownership of a nominal amount of stock (approximately 2½ percent) in plaintiff's parent, Southern Discount, from March 15, 1962 until March 25, 1969, and approximately 1 percent acquired in 1972 and disposed of in the following year.

8. Each of the states has its own minimum capitalization requirements for one seeking charter authority to conduct an insurance business. Arizona has the most moderate of such requirements. Thus, Southern qualified plaintiff under Arizona law, intending that it operate initially thereunder as a reinsurer, and was able to do so with an initial balance of invested capital and paid-in surplus of only $38,000.

9. Immediately following its formation plaintiff entered into an agreement (Treaty I) with American Bankers governing all future life and accident and health policies issued in respect to debtors of plaintiff's parent, Southern, and any of its other subsidiaries and affiliates.

10. Insofar as pertinent to this litigation, Treaty I provided:

ARTICLE I

American Bankers agrees to cede to *Consumer Life* and *Consumer Life* agrees to accept reinsurance to the extent set forth below:

One Hundred Per Cent (100%) of each and every Life policy and each and every Health and Accident policy (herein called "Life policies" and "Health and Accident policies") issued by American Bankers in respect to debtors of *Consumer Life* and its subsidiary and affiliated corporations. The liability of *Consumer Life* under said Life and Health and Accident policies shall follow the liability of American Bankers except that the liability of *Consumer Life* arising under its

reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable by *Consumer Life* under the provisions of Article V prior to the termination of this agreement.

ARTICLE II

This agreement applies to all said policies issued by American Bankers on or after the *1st* day of *July*, 1957.

ARTICLE III

American Bankers shall furnish *Consumer Life* on or before the 20th day of *July*, 1957 and on or before the 20th day of each month thereafter, a statement showing the following information on transactions of the preceding month:

A. On all Life policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason; and
(3) The amount of losses paid.

B. On all Health and Accident policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason;
(3) The amount of losses paid;

(4) The amount of losses reported and unpaid and the estimated amount of losses incurred and unreported at the end of the preceding month; and
(5) The amount of premiums earned.

For the purpose of computing premiums earned during any month on Health and Accident policies under this Article III, the sum of the premiums collected on policies written during the month less any premium returned because of cancellation or other reason during the month, shall be added to the unearned premium reserve at the beginning of the month on policies then in force, and from the total sum so obtained shall be subtracted the unearned premium reserve at the end of the month on policies in force at that time.

For the purpose of computing losses, losses reported and unpaid and losses incurred and unreported, the allocated loss expense shall be added to the amount of loss claims. In this connection the allocated loss expense shall be all claim expenses over and above the usual claim expenses incurred in the routine handling of a claim in the ordinary course of business, it being the intent of the parties hereto to include such expenses as the hiring of a special investigator, unusual travel expense in connection with the handling of a claim, attorney's fees arising from a claim and other expenses not incurred in the usual and ordinary course of handling a claim.

ARTICLE IV

In addition to the monthly statement set forth in Article III, American Bankers agrees to furnish *Consumer Life* on or before the 20th day of January each year and from time to time as may be requested by *Consumer Life*, but in no event more often than monthly, a statement containing the following information as at the end of the month preceding the statement:

A. The amount of reserve on all life policies then in force;

B. The amount of losses on Life policies reported and unpaid and the estimated amount of losses incurred but unreported;

C. The amounts of insurance on all Life policies;

D. Such other information as may be required to complete annual statements or other statements as required by law.

Consumer Life shall, at all reasonable times during this agreement, have full and free access to all books, records and files of American Bankers' office with respect to the business covered by this agreement.

ARTICLE V

In consideration of the reinsurance as set forth in Article I, the American Bankers agrees to pay monthly to *Consumer Life*, based on the statement set forth in Article III for the preceding month, and payable at the same time: (1) Eighty-seven and One-half Per Cent (87½%)

of the premiums collected less any premiums returned on all Life policies, and (2) Eighty-seven and One-half Per Cent (87½%) of the premiums earned on all Health and Accident policies.

Consumer Life agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted, for all losses actually paid during the preceding month on Life policies and all losses actually paid during the preceding month on Health and Accident policies plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

ARTICLE VI

American Bankers shall maintain all unearned premiums, loss and other reserves as may be required by law against all Health and Accident policies. *Consumer Life* shall maintain policy and other reserves as may be required by law on all Life policies.

ARTICLE VII

American Bankers agrees to pay all state, county, or city taxes which may be or become due in connection with the insurance sold or premiums collected on policies reinsured under this agreement.

ARTICLE VIII

American Bankers has furnished to *Consumer Life* and *Consumer Life* has acknowledged having received from American Bankers specimen forms upon which all said policies covered hereby are currently written. American Bankers reserves the right to make changes in such forms from time to time, but shall promptly notify *Consumer Life* of all such changes.

ARTICLE IX

The supervision and payment of all claims on policies covered by this agreement shall be handled by American Bankers and the decision of American Bankers in settling, rejecting or defending such claims shall be binding on *Consumer Life*.

ARTICLE X

In the event of the insolvency of the American Bankers, all reinsurance shall be payable directly to the liquidator, receiver or statutory successor of said American Bankers, without diminution because of the insolvency of American Bankers.

In the event of insolvency of American Bankers, the liquidator, receiver or statutory successor shall give *Consumer Life* written notice of the pendency of a claim on the policy reinsured within a reasonable time after such claim is filed in the insolvency proceeding. During the pendency of any such claim, *Consumer Life* may investigate such claim and interpose in the name of American Bankers (its liquidator, receiver or statutory successor,) but at its own expense, in the proceeding where such claims are to be adjudicated, any defense or defenses which *Consumer Life* may deem available to American

Bankers or its liquidator, receiver or statutory successor.

ARTICLE XI

All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the agreement obligation.

The court of arbitrators which is to be held in the city of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this agreement. One of the arbitrators is to be appointed by American Bankers, the second by *Consumer Life* and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the president of the American Life Convention.

The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

This agreement constitutes the entire contract between the parties and may not be altered, modified or in any ways amended except by an instrument in writing duly executed by the proper official of both parties.

ARTICLE XIII

This agreement may be terminated by either party effective on the last day of any month upon at least thirty (30) days written notice of the other party.

Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be signed and sealed by their duly authorized officers on this *28* day of *June*, 1957.

11. By amendments effective November 1, 1957 and April 1, 1958, American Bankers' retained share of the total premiums received annually in excess of $200,000 was reduced from 12½ percent, as provided in Article V of Treaty I, finding 10, *supra*, to 9½ percent.

12. Treaty I was further amended May 28, 1958, effective as of July 1, 1957, to revise the extent of plaintiff's interim liability as the reinsurer of American Bankers' exposure under the A & H coverages subject to the Treaty. At all times, however, plaintiff

reinsured the entire risk represented by those coverages, the only change being in the timing of its loss indemnity payments to American Bankers. At the time of this amendment plaintiff had accumulated a surplus fund of $130,000 from A & H premium receipts out of which to meet its reinsurance obligations which were averaging approximately $3,000 per month.

13. By virtue of the provisions of Articles I, II, V and XIII of Treaty I, finding 10, *supra*, plaintiff at all relevant times had an enforceable right to receive, albeit on an "as earned" basis, its entire share of premiums collected by American Bankers on A & H insurance sold by it to the debtors of Southern and its subsidiaries and affiliates after July 1, 1957. Under the provisions of the Treaty, construed in light of all of the factual circumstances on which it operated, the possibility that plaintiff would not receive its full share of all A & H premiums collected by American Bankers on coverages subject to the Treaty was so remote as to be negligible.

14. By virtue of the provisions of Articles I and XIII plaintiff assumed and completely retained the entire insurance risk of all A & H coverages sold by American Bankers after July 1, 1957 to Southern's debtors and those of its subsidiaries and affiliates.

15. For each of the years in suit plaintiff prepared and filed annual reports with the proper authorities in Arizona and Georgia, as required by the laws of those states. On those reports covering the years in which Treaty I was in force plaintiff re-

ported premium income from life insurance in the full amount of its 87½ percent share of premiums collected during the year by American Bankers. Correspondingly, it reported as a liability the full tabular reserve attributable to those life premiums. On A & H insurance, however, plaintiff reported as premium income only those amounts received from American Bankers representing an amortized portion of total premiums attributed to exposure deemed to have expired on a month-to-month basis. It reported no asset or other item representing the portion of A & H premiums on existing policies that it was contractually entitled to receive from American Bankers in the future. Those premiums and a correlative reserve therefor were carried by American Bankers on its own reports and had no effect on its status as a life insurance company for federal tax purposes. Thus, plaintiff reported no unearned premium reserve in respect to the A & H coverages that it reinsured and it reflected no other reserve liability relative to the A & H premiums that it was to receive in the future from American Bankers in accordance with the provisions of Treaty I.

16. The Georgia authorities never challenged plaintiff's reporting treatment of its Treaty I activities. The Arizona authorities examined plaintiff's report for 1961 and required no change in respect to Treaty I items.

17. By 1962 plaintiff had accumulated a sufficient surplus from profits realized under Treaty I to enable it to qualify under the laws of Georgia and

North Carolina to write insurance directly under the laws of those states. Accordingly, on April 18, 1962 plaintiff entered into a new insurance agreement, effective March 1, 1962, with American Bankers. That agreement, referred to herein as Treaty II, provided:

Article I

BASIS OF REINSURANCE

1. On and after the effective date hereof, the Ceding Company's liability under Credit Accident and Sickness policies issued directly by the Ceding Company on the policy forms specified in Schedule A, attached hereto, shall be reinsured automatically to the degree and in the manner hereinafter specified.

2. The reinsurance liability of American Bankers during 1962 shall be 80% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the ceding company at the beginning of each subsequent calendar year.

3. Reinsurance hereunder shall apply and be subject to all benefits and limitations included in policies issued by the Ceding Company and subject to reinsurance hereunder.

Article II

MODE OF CESSION

1. Reinsurance of Credit Accident and Sickness insurance issued or renewed by the Ceding

Company on and after the effective date of this Agreement shall be effected by the Ceding Company's mailing to American Bankers a reinsurance cession on a form of which a sample is attached hereto and marked Schedule B, not later than the twentieth day following the last day of the calendar quarter covered by the reinsurance cession. The liability of American Bankers shall:

(a) commence as of the effective dates of the reinsurance premiums, and

(b) continue only for the period covered by the reinsurance premiums.

2. In no event shall the reinsurance be in force and binding unless the policy issued by the Ceding Company to the insured is in force.

Article III

REINSURANCE PREMIUMS

1. The reinsurance premiums to be paid the American Bankers by the Ceding Company shall be the premiums charged the insured by the Ceding Company during the calendar quarter for the coverage reinsured.

2. The American Bankers will pay to the Ceding Company a commission of 50% of reinsurance premiums received, as specified in this Article, on reinsurance hereunder.

Article IV

OVERSIGHTS

1. American Bankers shall be bound as the Ceding Company is bound, and it is expressly understood and agreed that if non-payment of premiums within the time specified or failure to comply with the terms of this Agreement is shown to be unintentional and the result of misunderstanding or oversight on the part of either the Ceding Company or American Bankers, both the Ceding Company and American Bankers shall be restored to the positions they would have occupied had no such error or oversight occurred.

Article V

PAYMENT OF CLAIMS

1. At the end of each calendar quarter American Bankers shall reimburse the Ceding Company for American Bankers share of all claim payments made by the Ceding Company during the calendar quarter on policies reinsured hereunder.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

Article VI

EXPERIENCE REFUNDS

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience

Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

2. If P-Co-E-Cl is negative for a given calendar quarter such negative amount will be treated as an addition to the incurred claims in calculating the Experience Refund for the following calendar quarters.

Article VII

TAXES, ASSESSMENTS AND EXPENSES

Neither party hereto shall be liable to the other for taxes, assessments, or any expenses resulting from reinsurance hereunder. The Ceding Company shall furnish the American Bankers with all necessary information so that American Bankers will not be required to perform any office work other than the regular book-

keeping entries made in connection with reinsurance accounting.

Article VIII

INSPECTION OF RECORDS

American Bankers shall have the right at any reasonable time to inspect at the office of the Ceding Company all books and documents relating to the reinsurance under this Agreement.

Article IX

INSOLVENCY

1. In the event of insolvency of the Ceding Company, all reinsurance in force shall be payable to its liquidator or receiver without diminution because of the insolvency of the Ceding Company by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is understood, however, that in the event of the insolvency of the Ceding Company, the liquidator, receiver or statutory successor of the Ceding Company shall give written notice of the pendency of a claim against the Ceding Company on the policy reinsured with[in] a reasonable time after such claim is filed in the insolvency procedings and that during the pendency of such claim the American Bankers may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem avail-

able to the Ceding Company or its liquidators or receivers or statutory successor.

2. The expense thus incurred by American Bankers shall be chargeable against the Ceding Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Ceding Company solely as a result of the defense undertaken by American Bankers.

Article X

SETTLEMENT OF CLAIMS

1. American Bankers shall be liable to the Ceding Company for the benefits covered by reinsurance hereunder to the same extent as the Ceding Company is liable to the insured for such benefits and all reinsurance shall be subject to the terms and conditions of the particular form of policy under which the Ceding Company shall be liable.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

3. Whenever a claim is made under a policy of the Ceding Company, which has been reinsured hereunder, it shall be taken and considered by American Bankers to be a claim for the amount of reinsurance on such risk and American Bankers shall abide the issue as it shall be settled by the Ceding Company and shall pay the amount of reinsurance covered by the policy of reinsurance when the Ceding Company shall settle with the Claimant.

4. Any suit or claim may be contested or compromised on the part of the Ceding Company and in case of a reduction of the claim made upon the Ceding Company, American Bankers and the Ceding Company shall participate in such reduction in the ratio that each company's net liability bore to the total net liability prior to the reduction of the claim. Any unusual expenses incurred by the Ceding Company in defending or investigating any claim or taking up or rescinding any policy reinsured hereunder aside from routine investigations and other expenses incidental to the settlement of claims shall be shared in the same proportion.

5. In every case of loss, copies of proofs obtained by the Ceding Company shall likewise be taken as sufficient by American Bankers and copies thereof, together with a statement showing the amount paid on such claim by the Ceding Company shall be furnished to American Bankers before payment shall be demanded of it.

Article XI

ARBITRATION

1. All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this treaty from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitrators which is to be held in the City of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this Agreement. One of the arbitrators is to be appointed by the Ceding Company, the second by American Bankers and the third is to be selected by those two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the counsel for the Consumer Credit Insurors Association.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

Article XII

PARTIES TO AGREEMENT

This is an agreement solely between the Ceding Company and American Bankers. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Bankers and the insured or the beneficiary under any policy of the Ceding Company which may be reinsured hereunder.

Article XIII

DURATION

1. This agreement shall be effective as of the 1st day of March 1962, and may be terminated as of the end of any calendar quarter by either party giving to the other not less than 30 days' written notice.

2. Upon termination, as provided in this Article, the Ceding Company shall, within 30 days of the termination date, supply American Bankers with the information necessary to calculate the final experience refund as of the termination date. Payment of (a) the final experience refund,

(b) the unearned premium reserve held by American Bankers less unearned commissions thereon, and

(c) payment of the claim reserve held by American Bankers.

18. On December 2, 1964, effective October 1, 1964, plaintiff and American Bankers executed the following amendment to Treaty II:

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 2nd day of December, 1964, and effective the 1st day of October, 1964, by and between CONSUMER LIFE INSURANCE COMPANY OF PHOENIX, ARIZONA, hereinafter designated as "Ceding Company" and AMERICAN BANKERS LIFE AS-

SURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami, and State of Florida, hereinafter designated as "Company".

WITNESSETH:

WHEREAS, the Company and the Ceding Company entered into a Reinsurance Agreement on the 1st day of March, 1962; and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I, Paragraph (2) is hereby amended to read:

> The reinsurance liability of American Bankers shall be 65% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the Ceding Company at the beginning of each subsequent calendar year.

3. All other conditions are to remain the same.

19. On December 29, 1964, effective December 31, 1964, plaintiff and American Bankers executed the following further amendment to Treaty II:

> AMENDMENT TO Reinsurance Agreement between Consumer Life Insurance Company of Phoenix, Arizona, and American Bankers Life Assurance Company of Florida, of Miami, Florida, dated April 18, 1962. Article VI of above mentioned Reinsurance Agreement is hereby amended to read as follows:
>
> Article VI
>
> EXPERIENCE REFUNDS
>
> 1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:
>
> Experience Refund = (P-Co-E-Cl-N)
>
> where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.
>
> Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.
>
> E = an expense, profit, and contingency charges equal to .03P.
>
> Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

> N = negative carry-forward from prior quarter.
>
> 2. If a negative amount is obtained from the calculation of the Experience Refund for a given calendar quarter, such negative amount will be carried forward in calculating the Experience Refund for the following calendar quarter, provided, however, that any unamortized balance of such negative carry-forward will be dropped from the refund calculation after 20 quarters. The "first-in, first-out" principle will apply to the unamortization of two or more negative carry-forwards arising from the experience of different calendar quarters.
>
> IN WITNESS WHEREOF the parties hereto have caused this Amendment to be executed in duplicate this 29th day of December, 1964, and to be effective for calculating the Experience Refund due for the calendar quarter ending December 31, 1964.

20. By virtue of the provisions of Articles I, II, VI and XIII, and particularly those of Article VI dealing with Experience Refunds, plaintiff assumed the entire insurance risk under all of the A & H policies covered by Treaty II. Because of Article VI, American Bankers' pecuniary interest in Treaty II, aside from investment return on premiums temporarily held, was fixed at 3 percent of the A & H premiums covered by the Treaty, without regard to loss experience. Only if loss experience under the subject coverages exceeded 97 percent of premium income could American Bankers' receipt of its 3

percent participation be delayed to a subsequent quarterly period. The likelihood that loss experience on the A & H coverages subject to Treaty II would run as high as 97 percent was so remote as to be negligible and the parties knew this. They had accumulated extensive prior loss experience, both under Treaty I and prior thereto, with such coverage. That experience reflected losses ranging from 28 to 30 percent of premiums earned. On December 29, 1964 when the parties excuted the amendment of Article VI of Treaty II, as set forth in finding 19, *supra*, loss experience on A & H coverages subject thereto was running at the rate of 18 percent.

21. On its annual reports covering the A & H transactions subject to Treaty II plaintiff did not reflect any unearned premium reserves; this on the premise that by virtue of Treaty II, American Bankers was the reinsurer of the A & H coverages subject thereto and that, to the extent of such reinsurance, plaintiff was entitled to take a credit against (*i.e.*, to reduce) the reserves that it would otherwise be required to maintain as the originating carrier of such coverages. American Bankers conformed with this approach in preparing its own reports but its recognition of the reserves in question had no disqualifying effect on its status as a life insurance company for federal tax purposes.

22. The essence of insurance is risk-shifting and risk-distribution.

23. Reinsurance is insurance by the first insurer of the whole or some part of his interest in the risk created by his original contract of insurance.

24. Under Treaty I plaintiff reinsured the entire insurance risk created by American Bankers under the A & H coverages subject thereto. Under Treaty II American Bankers did not function as a reinsurer. Its function was rather that of a supplier of essentially clerical services for a fixed fee with plaintiff assuming and retaining the entire insurance risk under the coverages subject thereto.

25. In the opinion of Mr. Arthur Crooks Eddy, an actuary who testified as an expert for the plaintiff in this proceeding and for the plaintiff in *Penn Security Life Insurance Co.* v. *United States*, Ct. Cl. No. 109-68 (Tr. Judge Op. March 2, 1973), and *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (7th Cir. 1974), an insurer having an enforceable contractual right to receive premiums in the future respecting existing coverage on which it bears some or all of the insurance risk is obliged by prevailing state law and practice to reflect the amount of those premiums receivable as an asset on its annual reports and to concurrently reflect a concomitant liability, in the nature of an unearned premium reserve in the case of A & H coverage—a reserve relating to the underlying exposure assumed in consideration of the right to receive such premiums in the future.

26. The Georgia Code Annotated contains the following provisions, by section, applicable to the insurance activities in suit:

56-901. "*Assets*" *defined.*—In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

* * * *

(6) Premiums in the course of collection, other than for life insurance and annuity considerations, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly to the United States Government or by any state of the Union or by any of their instrumentalities;

(7) Installment premiums other than life insurance premiums to the extent of the unearned premium reserves carried thereon;

(8) Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon;

(9) The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under section 56-413;

(10) Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty;

* * * *

56-905. *Liabilities.*—In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

(3) With reference to life and disability insurance and annuity contracts:

(a) The amount of reserves on life insurance policies and annuity contracts in force, valued according to the tables of mortality, rates of interest, and methods adopted pursuant to this Title which are applicable thereto,

(b) Reserves for disability benefits, for both active and disabled lives,

(c) Reserves for accidental death benefits, and

(d) Any additional reserves which may be required by the Commissioner consistent with practice formulated or approved by him, on account of such insurance;

* * * *

56-906. *Unearned premium reserve.*—(1) With reference to insurance against loss or damage to property (except as provided in section 56-907) and with reference to all general casualty insurance and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.

(2) The Commissioner may require that such reserves shall be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed on each respective risk from the policy's date of issue. If the Commissioner does not so require, the portions of the gross premium in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:

Term for Which Policy Was Written	Reserved for Unearned Premium
1 year or less	1/2
2 years	1st year 3/4 2nd year 1/4
3 years	1st year 5/6 2nd year 1/2 3rd year 1/6
4 years	1st year 7/8 2nd year 5/8 3rd year 3/8 4th year 1/8
5 years	1st year 9/10 2nd year 7/10 3rd year 1/2 4th year 3/10 5th year 1/10
Over 5 years	pro rata.

(3) Unearned premium reserves on policies written for an intermediate period shall be calculated on a monthly pro rata basis.

(4) In lieu of computation according to the foregoing table, all of such reserves may be computed, at the option of the insurer, on a monthly or more frequent pro rata basis.

(5) After adopting a method of computing such reserve, a domestic insurer shall not change methods without approval of the Commissioner and a foreign or alien insurer shall not change methods without approval of the insurance supervisory official of the state of its domicile.

(6) This section does not apply to title insurance.

* * * *

56-908. *Reserves for accident and sickness insurance.*—For all accident and sickness policies the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under such policies and which shall not be less in the aggregate than the reserve according to the standards set forth in regulations issued by the Commissioner and, in no event, less than the pro rata gross unearned premium reserve for such policies.

27. The following sections of the Arizona Revised Statutes are germane to the insurance activities in suit:

§ 20-223. *Annual statement*

A. Each authorized insurer shall annually on or before March 31 file with the director a true statement of its financial condition, transactions and affairs as of the December 31 preceding. The statement shall be in such general form and context as approved by the national association of insurance commissioners for the kinds of insurance to be reported upon, and as supplemented for additional information required by the director.

* * * *

§ 20-501. *"Assets" defined*

In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

* * * *

5. Premiums in the course of collection, other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.

6. Installment premiums other than life insurance premiums, in accordance with regulations prescribed by the director consistent with practice formulated or adopted by the national association of insurance commissioners.

7. Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon.

8. The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under § 20-261.

9. Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty.

* * * *

§ 20-505. *Liabilities*

In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

3. With reference to life and disability insurance and annuity contracts:

(a) The amount of reserves on life insurance policies and annuity contracts in force, valued according to the tables of mortality, rates of in-

terest, and methods adopted pursuant to this title which are applicable thereto.

(b) Reserves for disability benefits, for both active and disabled lives,

(c) Reserves for accidental death benefits.

(d) Any additional reserves which may be required by the director consistent with practice formulated or approved by the national association of insurance commissioners, on account of such insurance.

* * * *

§ 20-506. *Unearned premium reserve*

A. With reference to insurance against loss or damage to property, except as provided in § 20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§ 20-508 and 20-510, and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.

B. The director may require that such reserve be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed on each respective risk from the policy's date of issue. If the director does not so require, the portions of the gross premiums in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:

Term for Which Policy Was Written	Reserve for Unearned Premium
1 year or less	1/2
2 years	1st year 3/4 2nd year 1/4
3 years	1st year 5/6 2nd year 1/2 3rd year 1/6
4 years	1st year 7/8 2nd year 5/8 3rd year 3/8 4th year 1/8
5 years	1st year 9/10 2nd year 7/10 3rd year 1/2 4th year 3/10 5th year 1/10
Over 5 years	Pro rata

28. On the basis of the proofs and representations of the parties the following numbered findings of fact were made by the Trial Judge in *Penn Security Life Insurance Co.* v. *United States*, Ct. Cl. No. 109-68:

> 1. Plaintiff was incorporated on August 8, 1955, under the statutes of the State of Missouri applicable to the organization of life insurance companies. It is empowered by its Articles of Incorporation and authorized by the insurance authorities of the State of Missouri to engage in the business of issuing contracts insuring or reinsuring against death or disability, and has carried on such business exclusively.
>
> * * * *

> 4. Plaintiff's principal business, until approximately 1966, consisted of reinsuring death and disability risks underwritten by unrelated insurance companies in respect to credit life insurance policies issued by those companies to Aetna and its loan customers. By 1967, plaintiff's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. Plaintiff today writes a complete portfolio of the standard forms of ordinary and term insurance contracts including individual and group life, accident and health, and surgical coverages, as well as credit insurance for borrowers and installment purchasers.
>
> * * * *
>
> 15. The determination of the Commissioner of Internal Revenue that plaintiff was not a "life insurance company" as defined in Section 801 of the Code in 1963, 1964, and 1965 was based upon his inclusion in plaintiff's "total reserves" of unearned gross premiums actually held by the ceding companies (*i.e.*, Old Republic, Pilot, and National Fidelity) in respect of disability benefits under credit life insurance policies (combined with health and accident insurance) issued by those companies to Aetna and its loan customers. The amounts of "unearned premiums" added by the Commissioner of Internal Revenue to plaintiff's "total reserves" as of December 31, 1962, 1963, 1964, and 1965 were as follows:

From	Unearned Premiums Attributed to Plaintiff 12-31-62	12-31-63	12-31-64	12-31-65
Old Republic	$ 183,342	$ 147,375	$ 145,833	$ 191,416
Pilot	728,821	782,726	724,445	829,480
National Fidelity	413,973	495,288	570,083	773,670
	1,326,635	1,425,389	1,440,351	1,794,566

The Government now concedes that unearned premiums under the Old Republic Disability Reinsurance Treaty are not attributable to taxpayer for purposes of qualification as a life insurance company.

16. The unearned premiums attributed to plaintiff by the Commissioner of Internal Revenue as of December 31, 1962, 1963, 1964, and 1965 were actually held by the ceding companies on those dates and were included in the unearned premium reserves shown on the annual statements which they submitted to the insurance authorities of the various states in which they did business. In recognition of their continuing obligations to their policyholders, the ceding companies were required, both from an actuarial standpoint and under state law, to establish such unearned premium reserves while they actually held the unearned premiums in order to have funds available to pay claims and refunds to their policyholders and to reflect the fact that they had received premiums from policyholders for insurance protection to be provided after the statement date. The annual statements of those

companies, in which the unearned premiums which the Commissioner of Internal Revenue now seeks to include in plaintiff's reserves were shown as unearned premiums of the ceding companies, were accepted by the insurance authorities in all the states in which the ceding companies did business.

* * * *

18. Plaintiff had separate reinsurance treaties covering life insurance risks and disability insurance risks with each of the ceding companies during the years in issue. Under the disability reinsurance treaties, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life insurance policies issued to Aetna and its loan customers. The treaties provided for payment of a monthly reinsurance premium equal to 98 percent (89 percent under the Old Republic treaty) of the premiums earned with respect to credit accident and health insurance in force during the previous month. The following excerpts from the Pilot treaty are typical:

Article I.

* * * Pilot Life agrees to reinsure with [Taxpayer] one hundred per cent (100%) of the total of all Credit Accident and Health issued by Pilot Life covering the debtors of Aetna Finance Company. * * *, and [Taxpayer] agrees to accept such reinsurance automatically.

Article II.

1. The liability of [Taxpayer] on all reinsurances shall begin simultaneously with that of

Pilot Life and in no event shall the reinsurance of [Taxpayer] be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of [Taxpayer] shall cease when the liability of Pilot Life ceases.

* * * *

Article III.

1. Reinsurance payments to [Taxpayer] shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with [Taxpayer].

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus unearned premium reserves on such policies at the beginning of the month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due [Taxpayer] shall be deducted and withheld by Pilot Life:

A. The following expenses which are assumed by [Taxpayer]:

(1) All premium, occupational and privilege taxes applicable to the insurance.

(2) The cost of policy forms.

(3) Any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) Any commissions paid to or retained by agents for writing the insurance; and

B. The total of all claims paid under reinsured policies during the period for which the premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, [Taxpayer] shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to [Taxpayer] for payment of monthly reinsurance premiums until all premiums on policies reinsured with [Taxpayer] prior to the termination have been earned, and [Taxpayer] shall nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with [Taxpayer] prior to the termination. After all reinsurance premiums have been paid, [Taxpayer] shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

* * * *

19. Plaintiff's disability reinsurance treaties with the ceding companies fell into the category

of "reinsurance ceded"; *i.e.*, they were solely contracts of insurance between two insurance companies (the "ceding company" and the "reinsurer"), and did not create any contractual obligation running from the reinsurer (plaintiff) to the policyholders of the ceding companies. Such reinsurance did not relieve the ceding companies of contractual liabilities to their policyholders, *e.g.*, the obligation to pay benefits and to refund unearned premiums in the event of cancellation or other termination of a policy before the expiration of its full term. Consequently, the mere fact that the ceding companies obtained reinsurance from plaintiff under these treaties did not affect their responsibility, under state law or under actuarial principles, to set up an unearned premium reserve to reflect the unearned premiums actually held by those companies or policies covered by reinsurance treaties with plaintiff. Ceding companies, however, may obtain a credit on their annual statement forms for unearned premium reserves actually transferred to a reinsurer since, as explained by plaintiff's expert, the liability for an unearned premium reserve "depends on whether you've got the money or not . . ."

29. By virtue of Articles I and III, subparagraph 5, of the Treaty set forth under paragraph 18 of the preceding finding the plaintiff in *Penn Security* assumed the entire insurance risk under the coverages subject thereto and had an enforceable contractual right to receive, over the respective lives of the individual coverages involved, substantially the entire premiums collected thereon from

the insureds by the ceding carriers. According to the testimony of Arthur Crooks Eddy in the present proceeding, a right to receive premiums in the future, such as Penn Security had under the treaties to which it was a party, must be reported to the state regulatory authorities as an asset and must be accompanied by a liability item in correlative amount, in the nature of an unearned premium reserve against the asset receivable.

30. During the period in suit in *Penn Security*, VERNON'S ANNOTATED MISSOURI STATUTES included the following provision:

> 376.410. *Insurance companies to maintain reserves—exemptions*
>
> Except as provided in subdivision (6) of this section, all companies organized under the laws of this state, and engaged in writing policies of accident or health insurance, or combination policies of accident and health insurance, and all other companies transacting such kinds of business in this state, shall maintain reserves thereon in accordance with the following requirements:
>
> (1) On all such policies actually written there shall be maintained an unearned gross premium reserve which reserve may be computed on a *pro rata* basis or such reserve may be computed at not less than fifty per cent of the gross premiums in force
>
> (2) On all such policies written on a noncancellable plan and under the terms of which

the company is obligated to renew or continue for a stated period, or to a stated age or for life, there shall be maintained active life reserves and reserves for losses in amounts not less than such minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(3) On all such policies other than those written on a noncancellable plan there shall be maintained reserves for losses in amounts not less than the minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(4) In the calculation of reserves required to be maintained under this section, proper credit shall be allowed for reinsurance in other companies licensed to do business in this state;

(5) In addition to the minimum reserves mentioned above the superintendent of insurance may also require such companies to maintain reserves for extraordinary losses in amounts not less than such minimum standards which the superintendent of insurance shall determine and prescribe after giving proper consideration to the terms and conditions of the policies involved;

(6) This section shall not be applicable to total and permanent disability benefits, or to accidental death benefits, contained in or supplementary to life insurance policies or other contracts and for which benefits the standard of valuation is prescribed by section 376.380.

31. In its federal income tax returns for the years in issue, plaintiff treated the reinsurance treaties (Treaties I and II) as it had in its annual statements. It reported the reserves on the life insurance policies on which it was reinsurer under Treaty I and on the life policies which it wrote directly during the subsequent period when Treaty II was in force but it did not report any unearned premium reserves on the accident and health policies covered by either treaty. By not taking those reserves into account, plaintiff's life insurance reserves were shown on its returns as totaling more than 50 percent of its total reserves. It therefore claimed qualification as a life insurance company under Section 801 of the Internal Revenue Code of 1954.

32. Following an audit the Internal Revenue Service issued notices of deficiency for the years in issue disallowing plaintiff's taxable status as a life insurance company. It did so on the premise that the unearned premiums on the accident and health insurance covered by Treaties I and II should have been included in taxpayer's total reserves. Had they been so included, plaintiff's life insurance reserves would have constituted less than 50 percent of its total reserves and it would not therefore have qualified as a life insurance company. Deficiencies were duly assessed accordingly. Following payment and the rejection of refund claims filed by plaintiff, this suit was seasonably brought.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that the plaintiff is not entitled to recover and its petition is dismissed.

APPENDIX B

IN THE UNITED STATES COURT OF CLAIMS

No. 463-70

(Decided October 22, 1975)

CONSUMER LIFE INSURANCE COMPANY

v.

THE UNITED STATES

E. Michael Masinter, attorney of record, for plaintiff. *James H. Landon* and *Hansell, Post, Brandon & Dorsey*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNET, *Judges*.

OPINION

KASHIWA, *Judge*, delivered the opinion of the court:

This is a single issue tax refund suit that arises out of a small loan company's entry into the insurance business through a wholly owned subsidiary that is formed especially for that purpose. The question is whether that subsidiary, the plaintiff in this proceeding, qualified for the tax treatment accorded a "life insurance company" by §§ 801 et seq. of the Internal Revenue Code of 1954. We hold for the plaintiff.

This case is before this court on a review of a recommended decision of Trial Judge George Willi. The court disagrees with the conclusions. A similar case, *Penn Security Life Insurance Co.* v. *United States* (Ct. Cl. No. 109-68), is decided contemporaneously herewith. Issues decided therein and applicable herein are disposed of by reference to said decision; but as hereafter shown, plaintiff in this case has raised new questions based on state regulatory statutes. This decision discusses these state statutes which defendant claims are relevant.

The facts are fully detailed in the findings of fact accompanying this opinion and will be repeated herein only to the extent necessary to an understanding of the result reached.

In 1957 Southern Discount Company (Southern), a Georgia corporation, was operating a well established and successful consumer finance business. Its customer-borrowers typically purchased term life and accident and health (A & H) insurance at the time that they obtained their loans. The premium charge for the entire coverage involved was thereupon paid

in full. The customers bought this protection, coextensive in both time and amount with the curtailment requirements of their borrowings, to provide a means of automatically servicing their debts to Southern in case of death or disability prior to full repayment. Georgia law prohibited Southern, as a loan company, from acting as an insurance underwriter with respect to such coverages. It was not forbidden, however, from functioning as a sales agent for insurance underwritten by a carrier duly qualified to conduct an insurance business in Georgia. American Bankers Life Insurance Company (American Bankers), a Florida corporation, was such a carrier.

Until 1957 Southern acted as a commission sales agent for American Bankers in respect to life and A & H insurance issued by the latter to Southern's borrowers. Under this arrangement, Southern received the maximum commission rate allowed by law; amounting to approximately 50 percent of the policyholder premiums. Despite the attractiveness of that return, for which it apparently had to do little more than place American Bankers' policies with its own borrowers, Southern concluded that it could reap even greater profits from this source if it could participate as an underwriter rather than just a sales agent. It was that determination that prompted Southern to form the plaintiff as a wholly owned subsidiary.

Southern surveyed state law to locate the jurisdiction that had the most modest capitalization requirements for a licensed insurer and found that it was

Arizona. Plaintiff was organized July 1, 1957 as an insurance company under an Arizona charter with an initial balance of invested capital and paid-in surplus of only $38,000. These resources were not sufficient to permit it to qualify as a direct insurer under Georgia law. It could, however, use its Arizona charter authority to operate as a reinsurer of Georgia and North Carolina coverages written by American Bankers—a duly authorized insurer in both of those states. American Bankers was willing to enter into a reinsurance treaty arrangement with plaintiff, under which it surrendered substantially all underwriting profit in return for a relatively minimal fixed fee, because it knew that if it refused, Southern would have no difficulty in replacing it with another qualified carrier. Thus, its alternative was outright exclusion from the insurance business generated by Southern's borrowers. Thereupon, on June 28, 1957, American Bankers entered into the first of two consecutive insurance treaties (Treaty I and Treaty II, respectively) with the plaintiff.

Under Treaty I, all life and A & H policies issued by American Bankers to debtors of plaintiff's affiliates (including the parent, Southern) on and after July 1, 1957 were to be fully reinsured with plaintiff which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved; A & H as well as life. As compensation for its reinsurance function, plaintiff was to receive 87½ percent (later increased to 90½

percent) of all premiums collected by American Bankers from the policyholders. The timing of these payments by American Bankers to plaintiff differed, however, as between life and A & H, although the agreement required monthly remittances in each instance. As already noted, American Bankers collected all premiums in full at the inception of coverage. The Treaty stipulated that as to life policies, American Bankers was, at the end of each month, to pay plaintiff its entire share of all life premiums collected from policyholders during that month. As to A & H, however, American Bankers was to pay plaintiff only the portion of its total share of premium receipts during that month that was ratably allocable to that month's coverage; the agreement being to pay over the remainder monthly on a pro rata basis spread over the balance of the coverage period. Thus, in respect to A & H, plaintiff never actually held any premium dollars attributable to a future period of coverage and risk exposure.

Finally, Treaty I provided for termination by either party upon thirty days written notice to the other. Termination was to be wholly prospective, the relevant clause specifying: "Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective."

As required by state law, plaintiff filed annual reports of its activities under Treaty I with the insurance regulatory authorities in Arizona and Georgia. On those reports it characterized its life and

A & H dealings differently. It did so by reporting both premium income and related reserves solely on the basis of actual dollar receipts for the year involved. This meant that for the life coverages it declared as premium income its entire percentage share of the premiums paid by policyholders during that year. Consonantly, it reported the full tabular reserve for all of such policies. As to A & H, however, it limited reported premium income to the annual aggregate of the incremental payments that had been received monthly from American Bankers. Moreover, it showed nothing on the asset side of the report representing the premiums on existing A & H policies that it was entitled under the Treaty to receive in the future. With premium income and asset balances thus restricted, plaintiff reported no reserves whatever in respect to the A & H coverages that it reinsured under Treaty I. As to those coverages, American Bankers included on its own annual reports an unearned premium reserve based on the amount of A & H premiums collected from policy holders but not yet paid over to the plaintiff. Neither the Georgia nor the Arizona regulatory authorities ever challenged or disapproved the method by which plaintiff reported its A & H reinsurance activities under Treaty I.

By 1962 plaintiff had accumulated enough earnings from operations under Treaty I to enable it to qualify as a direct insurer under Georgia and North Carolina law. It thereupon applied for and received such authority from the State of Georgia. From then

on plaintiff operated as the issuing company on all life and A & H policies sold to the loan customers of Southern and its affiliates. Treaty I, in which plaintiff's role was solely that of a reinsurer, was consequently no longer suited to its purposes. Accordingly, effective March 1, 1962, plaintiff and American Bankers entered into a new insurance treaty under which their roles were reversed; plaintiff functioning as the issuing or ceding carrier and American Bankers denominated the "reinsurer".

Treaty II applied only to A & H insurance; plaintiff having determined to underwrite all future life insurance by itself. The treaty provided that plaintiff, as the issuing or ceding company, would reinsure 80 percent of all future A & H policies with American Bankers. To that extent, plaintiff was to pay over to American Bankers on a quarterly basis all of the premiums collected from policyholders, American Bankers to return 50 percent of such amounts to the plaintiff as commissions. The Treaty contained a clause, entitled Experience Refunds, establishing a quarterly rebate due plaintiff in the amount of the total premium dollars ratably allocable to the expired portion of the term of policies for which such premiums had been collected, less the following deductions: (a) the amount of commissions paid plaintiff that was proportionate to the expired portion of the term of policies on which such commissions had been paid; (b) 3 percent of the earned premium dollars previously described; and (c) the sum of all claim payments made to

plaintiff during the quarter by American Bankers as reinsurer. For all practical purposes, this clause served to fix American Bankers' stake in the undertaking at a flat 3 percent of the premium dollars that it initially received from the plaintiff. Only if loss experience under the reinsured coverages exceeded 47 percent of premiums would American Bankers' 3 percent return be encroached. Moreover, such a pattern of adverse experience would have had to persist for the ensuing twenty consecutive quarters before such an encroachment became permanent. Loss experience on A & H policies under Treaty I had ranged from 28 to 30 percent. Finally, there were no circumstances under which American Bankers' return under Treaty II could exceed the 3 percent allotted to it therein.

On its annual reports to the state regulatory authorities covering 1962 and subsequent years, plaintiff declared no reserves relative to that portion of the A & H policies covered by the reinsurance language of Treaty II. Again, no state regulatory authority took exception to this aspect of plaintiff's reports.

The insurance industry is regulated by the states. A particular insurance company must meet the various industry requirements of its home state, and must satisfy the requirements of all states in which it is qualified to act as an insurer. The state requirements include standards for investments, maintenance of reserves, and accounting practices. The state insurance departments supervise policy forms, agency re-

lationships, and the general financial activities of the companies within their jurisdictions. This regulation is designed to preserve the solvency of the insurance companies for the protection of the policyholders. To implement their regulatory function, state insurance departments require companies to file annual reports. Because reports are required in all states in which a company is qualified to act as an insurer, a standard report form has been developed by the National Association of Insurance Commissioners, which is used in all fifty states. These reports disclose, among other things, the reserves being maintained by each company.

In addition to requiring annual reports, the various state insurance departments conduct regular triennial examinations of insurance companies. Where the volume of business warrants it as to a particular company, it is customary for representatives of several state insurance departments to work together on these examinations. The examinations are carried out at the offices of the company in question and may take as long as several months for large companies. Among the matters which are investigated in the course of such an examination are the reinsurance treaties to which a particular company is a party.

When a state insurance department is presented with a reinsurance agreement in existence between parties, its investigation will include a determination that each party has established adequate reserves according to its respective liabilities pursuant to the terms of the reinsurance agreement.

Plaintiff was the subject of triennial examinations in 1959 and 1963 by the insurance department of Arizona. American Bankers was the subject of triennial examinations in 1960 and 1963. Participants in the 1960 examination were from the insurance departments of Florida, North Carolina, Georgia, and Texas; and participants in the 1963 examination were from the insurance departments of Florida, Georgia, Arizona, and Arkansas. The reinsurance treaties between plaintiff and American Bankers were examined in detail in the course of the aforesaid examinations. The existence of reserves for accident and health insurance held by American Bankers on the policies covered by those treaties was clear to the examiners. Also the maintenance of the reserves by American Bankers under the treaties during Period I and Period II was approved in the course of the four examinations; no requirement or even suggestion was made in the examination reports that the reserves should be otherwise maintained.

For each of the years 1958 through 1964 plaintiff computed its federal income tax liabilities and filed its returns on the premise that it was taxable as a "life insurance company" within the meaning of that term as defined by Section 801 of the Internal Revenue Code of 1954. On audit, the Revenue Service determined that plaintiff did not qualify as a life insurance company entitled to the preferential tax treatment accorded such an entity and assessed deficiencies accordingly (except for 1961 in which additional liability was fully expunged by other adjust-

ments not in dispute). Plaintiff paid the assessments and upon formal disallowance of its seasonably filed claims for refund, brought this action in which the sole question for decision is that concerning plaintiff's qualification as a life insurance company for federal tax purposes in the years 1958, 1959, 1960, 1962, 1963, and 1964.

As pertinent here, Section 801 defines a life insurance company as follows:

> SEC. 801 [as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.
>
> (a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,
>
> comprise more than 50 percent of its total reserves (as defined in subsection (c)).
>
> * * * * *
>
> (c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Life insurance company status, it is seen, is made to depend solely on the character and composition of an insurance company's reserves. An insurance company merits life insurance company tax treatment if its life reserves amount to half or more of its total insurance reserves. Section 801(c) expressly directs that total reserves, the denominator portion of the fractional test, shall include three separate categories: (1) life reserves; (2) reserves for unearned premiums and for certain unpaid losses (the latter element not being involved in this suit); and (3) all other reserves required by law.[1]

Sections 1.801-3(e) and 1.801-5(b) of the Treasury Regulations on Income Tax (1962), endorsed by both parties to the present controversy, define unearned premiums and reserves required by law, respectively, as follows:

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[1] The last-mentioned category has been traditionally and centrally implicated in the federal taxation of insurance companies. *See Brown* v. *Helvering*, 291 U.S. 193, 201 (1934), and cases cited therein.

Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

Reserves required by law defined. For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

In this case there is no disagreement as to either the fact or the particular amount of plaintiff's life insurance reserves for each of the years in suit. Its qualification depends entirely on the question of its chargeability with reserves incident to the A & H policies to which it was a party under Treaties I and II; there being no dispute that reserves must be maintained by someone in respect to those policies. If those reserves are includable in plaintiff's total reserves, it concededly does not pass the 50 percent test of Section 801. If, as plaintiff says, they are chargeable to American Bankers rather than to itself, it does.

To dispel the notion that it was required to maintain A & H reserves of a type comprehended by Sec-

tion 801, plaintiff relies on (1) the language of the two insurance treaties under which it operated with American Bankers; (2) the testimony of a well-traveled actuarial expert, Arthur Crooks Eddy; (3) the fact that the state insurance regulatory personnel tacitly approved plaintiff's annual report forms showing no A & H reserves; and (4) Trial Judge Fletcher's opinion in *Penn Security Life Ins. Co.* v. *United States* (Ct. Cl. No. 109-68, decided March 2, 1973).

Plaintiff's argument is simply that plaintiff was chargeable with no A & H unearned premium reserves because under both of the Treaties it received premium dollars only after the period of exposure to which those dollars related had expired. Accordingly, plaintiff says, since all the premiums that it received were, in point of time, already "earned" when it got them, there was no occasion for it to maintain a reserve for "unearned" premiums. Testifying as plaintiff's expert, Mr. Eddy repeatedly opined that this feature of the Treaties, governing custody of prepaid premium dollars, was dispositive of the participants' respective reserve obligations, *i.e.*, that since it was American Bankers that physically held all of the A & H premium dollars allocable to the unexpired portion of the terms of the underlying policies, it was American Bankers, not plaintiff, that was obligated to carry the reserves for those policies. In this regard, his testimony was the same as it apparently had been in *Penn Security*, *supra*. In the latter case, the relevant particulars of the fac-

tual situations involved were virtually identical to those presented by Treaty I.

Defendant's argument is that plaintiff's total reserves in the reserve ratio must include the unearned premium reserves on the accident and health policies because those reserves must be attributed to the company ultimately liable for the insurance risks. Alternatively, if the unearned premium reserves must be required by law to be recognized, they were so required here.

Issued contemporaneously with this opinion is the per curiam decision in *Penn Security Life Insurance Co.* v. *United States* (Ct. Cl. No. 109-68). That case involves life insurance company qualification and the provisions of § 801 dealing with health and accident insurance. The situation is similar to this case with that taxpayer reinsuring risks written by three unrelated insurance companies under credit life and accident and health policies on the lives and health of debtors of taxpayer's parent which made consumer loans through subsidiaries operating finance offices. That opinion disposes of the issue under § 801(c)(2), unearned premiums, with the court concluding against attribution to plaintiff of the unearned premium reserves held by the ceding companies. We, therefore, consider the question settled. However, this leaves for determination here the § 801(c)(3) issue, insurance reserves required by law.

The defendant's major argument in this case is that the reserves were required by law because Arizona Revised Statutes Annotated § 20-501(5) and

(9)[2] apply in that the premiums were assets of the

[2] § 20-501. *"Assets" defined*

"In any determination of the financial condition of an insurer, there shall be allowed as assets only such assets as are owned by the insurer and which consist of:

"1. Cash in the possession of the insurer, or in transit under its control, and including the true balance of any deposit in a solvent bank or trust company

* * * *

"5. Premiums in the course of collection, other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.

"6. Installment premiums other than life insurance premiums, in accordance with regulations prescribed by the director consistent with practice formulated or adopted by the national association of insurance commissioners.

"7. Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon.

"8. The full amount of reinsurance recoverable by a ceding insurer from a solvent reinsurer and which reinsurance is authorized under § 20-261.

"9. Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty.

"10. Deposits or equities recoverable from underwriting associations, syndicates and reinsurance funds, or from any suspended banking institution, to the extent deemed by the director available for the payment of losses and claims and at values to be determined by him.

"11. All assets, whether or not consistent with the provisions of this section, as may be allowed pursuant to the annual statement form approved by the national association of insurance commissioners for the kinds of insurance to be reported upon therein.

"12. Other assets, not inconsistent with the provisions of this section, deemed by the director to be available for the

plaintiff because they were "the course of collection" and they were "withheld by a solvent ceding insurer under a reinsurance treaty." We interpret these sections to mean that they refer to amounts already due and unpaid. The definition of assets under § 20-501 refers to items in the possession of the taxpayer or to which the taxpayer has an enforceable claim. Without including the unearned premium in taxpayer's assets, there can be no unearned premium reserve charged against that item. The Arizona provisions do not apply to plaintiff's circumstances.

Turning to the liability side of the statute, defendant argues that § 20-505[3] requires that plaintiff establish reserves on the accident and health

payment of losses and claims, at values to be determined by him."

[3] § 20-505. *Liabilities*

"In any determination of the financial condition of an insurer, capital stock and liabilities to be charged against its assets shall include:

* * * *

"3. With reference to life and disability insurance and annuity contracts:

* * * *

"(b) Reserves for disability benefits, for both active and disabled lives,

* * * *

"(d) Any additional reserves which may be required by the director consistent with practice formulated or approved by the national association of insurance commissioners, on account of such insurance.

"4. With reference to insurance other than specified in paragraph 3 of this section, and other than title insurance, the amount of reserves equal to the unearned portions of the gross premiums charged on policies in force, computed in accordance with this article."

* * * *

policies. It would appear from reading this statute that liabilities of an insurer "charged against its assets" implies that there were corresponding assets in the first place. Since there were not, this statute is inapplicable. Section 20-506A,[4] referring to disability insurance, provides that "every insurer shall maintain an unearned premium reserve on all policies in force." If there are two or more insurers on the same policy, they are not all meant to keep a reserve. This is how the state administrative practice operates. As long as someone has the reserve, this is sufficient.

Under Treaty II plaintiff resinsured with American Bankers. This was authorized under Code of Georgia Annotated § 56-413.[5] Section 56-906

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[4] § 20-506. *Unearned premium reserve*

"A. With reference to insurance against loss or damage to property, except as provided in § 20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§ 20-508 and 20-510, and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force."

[5] § 56-413. *Authorized reinsurance.* — "(1) An insurer shall reinsure its risks, or any part thereof, only in solvent insurers having surplus to policy holders or trusteed funds on deposit in the United States for the benefit of their policyholders not less in amount than the paid-in capital required under this Title of a domestic stock insurer authorized to transact like kinds of insurance.

"(2) An insurer shall so reinsure in such alien insurers only as either (a) are authorized to transact insurance in at least one state of the United States, or (b) have in the United States a duly authorized attorney-in-fact to accept service of legal process against the insurer as to any liability which might arise on account of such reinsurance, or (c)

(2)[6] provides for a deduction of reinsurance from

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may be approved by the Commissioner. In the event reinsurance is placed which is not in compliance with the foregoing provisions, the ceding insurer shall not be allowed credit for such reinsurance either as an asset or deduction from liability, nor may it increase any amounts it is authorized to have at risk because of such reinsurance.

"(3) No credit shall be allowed, as an asset or as a deduction from liability, to any ceding insurer for reinsurance nor increase the amount it is authorized to have at risk unless the reinsurance is in insurers either authorized to do business in this State, or which have been approved by written order of the Department filed in its office and which order has not been subsequently disapproved; Provided, however, that such credit shall be allowed for reinsurance ceded to unauthorized alien assuming insurers, if such insurers have maintained in the United States for not less than 10 years immediately preceding such reinsurance a trust fund of not less than $50,000,000 available for the purpose of protecting policyholders in the United States. Nor shall such credit be allowed unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer.

* * * *

"(5) Notwithstanding the provisions of this Code, full credit shall be allowed a ceding insurer, as an asset or as a deduction from liability, for all reinsurance which may be in effect or which may be hereafter effected under any contract or reinsurance in effect on the 31st day of December 1959, and any continuations or renewals of such contract of reinsurance. Provided, however, that no new insurance risk shall be ceded after two years from the effective date of this Title unless such reinsurance contract meets all the standards set forth in this Title."

[6] § 56-906

"(2) The Commissioner may require that such reserves shall be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as com-

gross premiums before computing the unearned premium reserve. Arizona Revised Statutes Annotated § 20-261 [7] and § 20-506B [8] are similar. Defendant

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puted on each respective risk from the policy's date of issue. If the Commissioner does not so require, the portions of the gross premium in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:"

* * * *

[7] § 20-261. *Authorized reinsurance*

"A. An insurer shall reinsure its risks, or any part thereof, only in solvent insurers having surplus to policyholders not less in amount than the paid-in capital required under this title of a domestic stock insurer, other than a limited stock insurer, authorized to transact like kinds of insurance. A domestic limited stock life insurer may accept reinsurance of the risks of other such limited stock insurers and of domestic benefit insurers.

"B. An insurer shall so reinsure in such alien insurers only as either are authorized to transact insurance in at least one state of the United States, or have in the United States a duly authorized attorney-in-fact to accept service of legal process against the insurer as to any liability which might arise on account of such reinsurance.

"C. No credit shall be allowed, as an asset or as a deduction from liability, to any ceding insurer for reinsurance unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer nor unless under the reinsurance contract the liability for such reinsurance is assumed by the assuming insurer or insurers as of the same effective date."

* * * *

[8] § 20-506

"B. The director may require that such reserves be equal to the unearned portions of the gross premiums in force after deducting reinsurance in solvent insurers as computed

argues that Treaty II is a Surplus Aid contract in that since plaintiff did not reinsure its risks despite the formalities, the treaty did not qualify as authorized reinsurance and plaintiff could not take credit for the reserves. In answer to this, it can only be said that plaintiff did reinsure its risk. American Bankers was responsible for the risk and even though it only kept 3 percent of the premiums, in the event that losses had eaten into the 3 percent, this would have been American Bankers' loss, not plaintiffs.

Defendant then argues that even if Treaty II is operative, plaintiff would have to re-establish the reserve as an offsetting liability to the asset required under paragraph 8 of § 20-501 of the Arizona law. That section is directed primarily toward loss reimbursements for losses paid directly by the ceding company. Therefore, there is no asset belonging to plaintiff because plaintiff does not have an enforceable claim of right against American Bankers.

We observe that the Arizona Code relating to insurance companies provided under § 20-152 for the director of insurance to certify the facts of violation of any provision to the attorney general for enjoining the violation. We also observe that the Georgia Code relating to insurance companies provided under

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on each respective risk from the policy's date of issue. If the director does not so require, the portions of the gross premiums in force, less reinsurance in solvent insurers to be held as a premium reserve, shall be computed according to the following table:"

* * * *

§ 56-214 that the Commissioner may institute legal proceedings for the enforcement of any provisions of the act. For the years in question, none of these actions were taken by either of the state offices in charge. With relation to doubtful or ambiguous statutes, it is generally accepted that in the absence of a court decision, the interpretation placed thereon by the regulatory body charged with enforcement thereof is compelling authority. Federal courts have applied this rule to state administrative interpretations or actions under state statutes. We believe that the language of the court in *Salt Lake County* v. *Kennecott Copper Corp.*, 163 F.2d 484, 489 (10th Cir. 1947) *cert. denied*, 333 U.S. 832, adopting a state administrative interpretation of an ambiguous state statute, is pertinent herein:

> * * * Both the Supreme Court of Utah and this court are firmly committed to the familiar principle of law that in the interpretation of a doubtful or ambiguous statute, the long-continued and uniform interpretation of the administrative agency or authority charged with its administration is entitled to great weight and will not be overturned, except for cogent reasons. An administrative interpretation does not avail to overcome a statute which is so plain in its commands that it leaves nothing for construction; but ordinarily in case of doubt or ambiguity, it is entitled to great weight and will not be overthrown, except for cogent reasons. *State Board of Land Commissioners* v. *Ririe*, 56 Utah 213, 190 P. 59; *Utah Hotel Co.* v. *Industrial Commission*, 107 Utah 24, 151 P.2d 467, 153 A.L.R. 1176; *Utah Power & Light Co.* v. *Public Service Commission*, 107 Utah 155, 152 P.2d 542; *E. C. Olsen Co.* v. *State Tax Commission*, Utah, 168 P.2d 324; *Baze* v. *Scott*, 10 Cir., 106 F.2d 365; *United States* v. *Magnolia Petroleum Co.*, 10 Cir., 110 F.2d 212; *Standard Surety & Casualty Co.* v. *State of Oklahoma*, 10 Cir., 145 F.2d 605. * * *

We believe that the Court's language in *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 139-140 (1944), explains the basic reason for the rule and we deem it appropriate in the present case:

> There is no statutory provision as to what, if any, deference courts should pay to the Administrator's conclusions. And, while we have given them notice, we have had no occasion to try to prescribe their influence. The rulings of this Administrator are not reached as a result of hearing adversary proceedings in which he finds facts from evidence and reaches conclusions of law from findings of fact. They are not, of course, conclusive, even in the cases with which they directly deal, much less in those to which they apply only by analogy. They do not constitute an interpretation of the Act or a standard for judging factual situations which binds a district court's processes, as an authoritative pronouncement of a higher court might do. *But the Administrator's policies are made in pursuance of official duty, based upon more specialized experience and broader investigations and infor-*

mation than is likely to come to a judge in a particular case. They do determine the policy which will guide applications for enforcement by injunction on behalf of the Government. Good administration of the Act and good judicial administration alike require that the standards of public enforcement and those for determining private rights shall be at variance only where justified by very good reasons. The fact that the Administrator's policy and standards are not reached by trial in adversary form does not mean that they are not entitled to respect. This Court has long given considerable and in some cases decisive weight to Treasury Decisions and to interpretative regulations of the Treasury and of other bodies that were not of adversary origin. [Emphasis supplied.]

We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.

See *New York State Department of Social Services* v. *Dublino*, 413 U.S. 405, 420-421 (1973); *NLRB* v. *Boeing Co.*, 412 U.S. 67, 74-75 (1973); *CBS* v. *Democratic National Committee*, 412 U.S. 94, 121

(1973); *Trafficante* v. *Metropolitan Life Insurance Co.*, 409 U.S. 205, 210 (1972); *Udall* v. *Tallman*, 380 U.S. 1, 16-18 (1965); *Travelers Indemnity Co.* v. *Wells*, 316 F.2d 770, 773 (4th Cir. 1963); *Barrington Manor Apartments Corp.* v. *United States*, 198 Ct. Cl. 298, 304, 459 F.2d 499, 502-503 (1972); *Alabama* v. *United States*, 198 Ct. Cl. 683, 692, 461 F.2d 1324, 1329-30, *cert. denied*, 409 U.S. 1023 (1972); *Inter-City Truck Lines, Ltd.* v. *United States*, 187 Ct. Cl. 290, 295, 408 F.2d 686, 688 (1969); *Cornman* v. *United States*, 187 Ct. Cl. 486, 492, 409 F.2d 230, 233, *cert. denied*, 396 U.S. 960 (1969); *DeLano* v. *United States*, 183 Ct. Cl. 379, 388, 393 F.2d 517, 521 (1968); *Ganse* v. *United States*, 180 Ct. Cl. 183, 189, 376 F.2d 900, 904 (1967); *Citizen Band of Potawatomi Indians* v. *United States*, 179 Ct. Cl. 473, 486-487, 391 F.2d 614, 621 (1967), *cert. denied*, 389 U.S. 1046, 390 U.S. 957 (1968); *Crawford* v. *United States*, 179 Ct. Cl. 128, 142-143, 376 F.2d 266, 274-275 (1967), *cert. denied*, 389 U.S. 1041 (1968); *cf. Federal Maritime Commission* v. *Seatrain Lines, Inc.*, 411 U.S. 726, 745 (1973); *Love* v. *Fitzharris*, 460 F.2d 382, 385 (9th Cir. 1972), *vacated*, 409 U.S. 1100 (1973).

Finally, with relation to the testimony of Mr. Sturtevant, who testified that the unearned premium reserve as reported by American Bankers and plaintiff was permitted "unwittingly" by the Georgia insurance authorities, we have reviewed his testimony and it does not change our interpretation of the Georgia law above expressed.

For the foregoing reasons, we hold that the plaintiff is entitled to recover.

NICHOLS, *Judge*, dissenting:

The dissent in *Penn Security Life Insurance Company* v. *The United States*, Ct. Cl. No. 109-68 announced this date is to be deemed as being applicable to this case.

FINDINGS OF FACT

History of the Controversy

1. For each of the taxable years 1958 through 1965, plaintiff filed a timely tax return and paid all taxes shown thereon to be due. The taxes paid in said years were as follows:

1958: $48,144.32	1961: $17,777.24	1964: $17,726.51
1959: $72,405.55	1962: $17,047.52	
1960: $52,377.05	1963: $43,790.32	

Such tax liability of plaintiff in all such years was computed in accord with Section 802 of the Internal Revenue Code of 1954.

2. Under date of February 20, 1969, the Acting Regional Commissioner, Internal Revenue Service, Southeast Region, sent plaintiff a notice of deficiencies in federal income taxes in the aggregate amount of $233,762.75, plus interest, for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963, and 1964. (Recomputation for 1961 resulted in a refund due

plaintiff.) The statement accompanying said notice of deficiency set forth the reasons for the alleged deficiencies in federal income taxes as follows:

> "It is determined that for your taxable years 1958, 1959, 1960, 1962, 1963 and 1964, you did not qualify as a life insurance company within the meaning of section 801 of the Internal Revenue Code of 1954, entitling you to taxation under section 802 of the 1954 Code. Consequently, your taxable income is being computed under Section 832 of the 1954 Code. This determination is based on the following:
>
> "(1) You did not compute or estimate your life insurance reserves on credit life contracts on the basis of a recognized Mortality Table and assumed rates of interest, as required by section 801(b) of the 1954 Code, and/or
>
> "(2) You did not reflect in your total reserves, defined in Section 801(c) of the 1954 Code certain unearned premiums on accident and health contracts under certain reinsurance agreements which should have been included therein. Accordingly, when your total reserves are corrected, your life insurance reserves as reported, even if recognized as having been computed or estimated on a basis of a recognized mortality table, would not exceed 50% of your correct total reserves pursuant to section 801(a) of the 1954 Code."

3. On or about July 30, 1969, plaintiff paid to the District Director the aggregate amount of $351,393.88 for additional federal income taxes and interest thereon for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963, and 1964.

4. On or about October 14, 1969, plaintiff filed with the District Director Claims for Refund of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above. On or about June 26, 1970, plaintiff filed amended Claims for Refund of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above.

5. On or about October 27, 1970, the District Director notified plaintiff that the aforesaid amended Claims for Refund for the overpayment of taxes and interest had been disallowed.

6. Plaintiff filed its Petition in this Court on December 30, 1970, for recovery of income taxes and interest paid by plaintiff with respect to its claims for its taxable years 1958, 1959, 1960, 1962, 1963, and 1964.

7. Jurisdiction over the subject matter of this action is conferred upon this Court under Section 1346 (a) (1), Title 28, United States Code.

Background of Controversy

8. Plaintiff was incorporated as a stock insurance company under the Insurance Code of the State of Arizona on June 26, 1957.

9. Since its incorporation, all of the outstanding stock of plaintiff has been owned by Southern Discount Company (hereinafter referred to as "Southern Discount"), which was during all years pertinent to this lawsuit a Georgia corporation licensed under the consumer finance laws of the states in

which it operated, and was engaged in the consumer finance business. These state laws forbade Southern Discount from acting as an insurance company. They did, however, permit Southern Discount to act as an agent for other insurance companies.

10. Prior to the incorporation of plaintiff, Southern Discount acted as agent for various insurance companies who wrote insurance on the lives and health of Southern Discount's borrowers.

11. Credit life and accident and health insurance is sold in connection with a loan of money or an installment sale of tangible personal property. Credit life insurance, generally defined, is term insurance on the lives of debtors, with their creditors as beneficiaries, in amounts at least sufficient to discharge their indebtedness in case of death. Sometimes the life coverage is combined with accident and health coverage. Such coverage pays the debtor's monthly installments during the period within the policy term in which he is totally disabled (*i.e.*, unable to work) because of accident or sickness, provided that the disability lasts beyond a minimum or "waiting" period. Coverage may be conditioned upon the permanent as well as total disability of the debtor. When life and accident and health coverage are provided in one contract, the respective premiums are separately stated.

12. As agent in the sale of such insurance, Southern Discount was able to share in its profitability by earning a commission, the amount of which, however, was limited by state law. By causing plaintiff

to be formed, Southern Discount was able to participate to a greater degree in the profitability of this business, when it was profitable, by actually engaging in the insurance underwriting function either directly or through its reinsurance.

13. The initial capital and paid-in surplus upon the incorporation of plaintiff in 1957 was $38,000.00. In 1959 plaintiff's stated capital was increased by $175,000.00 so as to qualify plaintiff to write insurance in the State of Georgia.

14. Plaintiff's Articles of Incorporation provide, among other powers designated therein, that the nature of the business, and objects or purposes to be transacted, promoted or carried on are:

> "(a) To insure, in its own proper and corporate name, the lives of persons and all insurance appertaining thereto, including, but not limiting the generality of the foregoing: term, industrial, retirement income, ordinary, modified, single premium, limited payment, group and all other types and forms of contracts of insurance upon or relating to the lives of persons in connection with the extension of credit to such persons.
>
> (b) To reinsure all or a part of any risk, class of risks, or all of the risks of the Company with any other insurance company or companies, and to accept such reinsurance from any other insurance company or companies, as allowed by law."

15. During all of the taxable years in issue in this case, plaintiff was licensed by the Insurance

Commissioner of the State of Arizona to transact life and disability insurance business. During the taxable years in issue the Arizona Department of Insurance conducted regular examinations of plaintiff's business activities and reports of examination were issued in 1959 and 1963.

16. American Bankers Life Assurance Company (hereinafter referred to as "American Bankers") is an insurance company licensed to engage in the life and disability insurance business under the laws of the State of Florida.

17. Other than as a party to certain treaties described more particularly below, American Bankers was totally unrelated to plaintiff at its inception and has remained an unrelated company except for its ownership of a nominal amount of stock (approximately 2½%) in plaintiff's parent corporation, Southern Discount, from March 15, 1962, until March 25, 1969, and approximately 1% acquired in 1972 and disposed of in the following year.

18. Reinsurance is a transaction in which an insurance company (the writing company, or ceding company) transfers, at least temporarily, the responsibility for all or a portion of the claims on which it may eventually be liable under the policies it has written, to another company (the reinsurer). The ceding company pays the reinsurer consideration for assisting the ceding company in spreading, or averaging, its liabilities or risk over time. Reinsurance may be entered into for numerous reasons, including freeing one company's capital or surplus

from restrictions imposed for reserves required, spreading risks over time, avoiding catastrophic losses, the alliance of a small, new company with an older, experienced company for business purposes, sharing profitability of the industry where business considerations require that, and avoiding fluctuations of yearly earnings.

19. During the years 1958 through 1961, plaintiff's business consisted of reinsuring all policies of insurance against the death or disability of debtors of Southern Discount and certain of its subsidiaries, which insurance policies had been issued by American Bankers. For plaintiff to have written insurance directly, rather than to have acted as a reinsurer, plaintiff would have been required to possess total stated capital and capital surplus of some $400,000.00 at this time in the State of Georgia. Plaintiff's intent was to act as a reinsurer, permissible with a smaller capital investment, and increase its surplus through the profitability of the business until plaintiff could qualify to write insurance directly. This method of conducting business relieved Southern Discount, plaintiff's parent company, from the financial burden of contributing to plaintiff's capital a large amount of cash and thereby enabled Southern Discount to utilize its available cash to produce a more attractive return through its consumer lending business.

20. This reinsurance was effected pursuant to the terms of a reinsurance treaty entered into by the parties and dated June, 1957, which agreement was

amended from time to time thereafter. (This period is hereafter referred to as "Period I" and this treaty and its amendments as "Treaty I." See paragraphs 56-58.)

21. The reinsurance treaties executed by plaintiff and American Bankers were arms-length agreements entered into for valid business purposes by unrelated parties.

22. American Bankers realized that if Southern Discount created a subsidiary insurance company which operated alone or under reinsurance treaties with other companies, the insurance business generated by loans on Southern Discount's customers would be lost completely by American Bankers.

23. In 1962, plaintiff having qualified to write insurance directly in the States of North Carolina and Georgia, its primary business became the direct writing of life and accident and health insurance on the debtors of Southern Discount and certain of its subsidiaries. This business continued to be plaintiff's primary business throughout the remainder of the years in issue ("Period II"), although plaintiff continued to reinsure certain policies under Treaty I until they expired according to their terms.

24. A certain percentage of the accident and health policies written directly by plaintiff during Period II were reinsured by American Bankers pursuant to the terms of a Reinsurance Treaty entered into between the parties on April 18, 1962. ("Treaty II." See paragraphs 59-61.)

25. Treaty II was entered into by plaintiff and American Bankers in 1962 for valid business reasons. The cession to American Bankers, on an "as written" basis, as described below, of a majority of the credit accident and health insurance which plaintiff wrote meant that plaintiff was not required under state law to maintain any unearned premium reserves on said insurance. Had full reserves, in the amount of 100% of the unearned premiums, been maintained by plaintiff with respect to said insurance, plaintiff's earnings and the consolidated earnings and capital of Southern Discount would have been adversely affected, with consequent damage to Southern Discount's borrowing power, which was of great import in its primary business.

26. Treaty II was an arms-length agreement between plaintiff and American Bankers. In addition to its effect on plaintiff's reserve requirements, Treaty II permitted plaintiff to dilute the effect on its capital and surplus at any given time, of accident and health insurance claims, thus serving the traditional role of reinsurance in deferring risk and providing protection for plaintiff and its customers in the event of any catastrophic loss experience, since American Bankers' obligations under the treaty were not limited in any way.

Qualification as a Life Insurance Company

27. Section 801 of the Internal Revenue Code of 1954 provides an objective test for determining whether an insurance company is a "life insurance

company" and therefore permitted to reports its income in the method prescribed by Section 802. The qualification formula may be expressed in terms of the following fraction, the quotient of which must be more than 50 percent in order for an insurance company to qualify as a life insurance company.

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on noncancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

28. Plaintiff did not physically hold, nor did it exercise control over, those unearned premiums representing accident and health insurance reserves which the Commissioner of Internal Revenue attributed to plaintiff for purposes of measuring plaintiff's "total reserves." The accident and health reserves were held by American Bankers and the investment income therefrom received by it.

29. Plaintiff maintained life insurance reserves with respect to life insurance reinsured pursuant to Treaty I. Similarly, plaintiff maintained life insur-

ance reserves with respect to life insurance written by plaintiff during Period II.

30. Historically, life insurance reserves are maintained by an insurance company to enable the company to pay those claims which may reasonably be expected to result from the life insurance policies it has issued. The computation of life insurance reserves is based upon mortality tables which contain statistics as to average life expectancies for certain ages and sexes. By applying these statistics to the ages and sexes represented by a company's actual policyholders, a reasonably accurate prediction of the amount necessary to meet future claims may be made. (Although the amount will vary according to the mix of policyholders for any particular company, the amount of reserves normally required was approximately 40 percent of premiums received for the policies covered by Treaty I.)

31. Traditionally, whether because accident and health insurance exposure was initially incapable of being measured statistically (although records have been maintained sufficiently by this time that a reasonable reserve requirement could probably be reached by using statistics), or perhaps because this insurance, unlike life insurance, is usually cancellable, accident and health reserves are required to be computed in terms of how much of a premium would have to be refunded to a policy holder in the event the policy were cancelled at any particular time during its term. The reserve so maintained is referred to as the "unearned premium reserve." This method of establishing reserves is the established method of

computing reserves for health and accident insurance.

32. All credit life and credit accident and health policies issued by American Bankers and reinsured by plaintiff, and those issued by plaintiff and reinsured by American Bankers, provided for payment of the entire premium at the time of issuance. This is referred to in the industry as "single premium" payment. When a health and accident premium under such a "single premium" policy is first paid by the insured, it is wholly "unearned" in that the entire premium has been paid for coverage over the full term of the policy, which has not yet been provided. Such unearned portion is set aside on the books and records of the company as the unearned premium reserve. As the term of the policy expires with the passage of time, the premium becomes "earned" to the extent of such expiration, since that portion was paid for coverage which was provided during the expired portion of the policy.

33. An unearned premium reserve thus measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of such premiums that represent payment for insurance to be provided after the reserve valuation date.

34. In the event that the policies issued by American Bankers or by plaintiff to the debtors, in Period I or II, were cancelled by some act prior to the expiration of their original terms, the refund of the unearned portion of the premiums would be made in

pursuance to their terms in accordance with a prescribed formula known as the Rule of 78.

35. Under the Rule of 78 or "sum-of-the-digits" method, the unearned premium is computed by applying changing fractions each year (or month, if unearned premiums are determined monthly) to the premium paid by the insured. The numerator of the fraction changes each year (or month) to a number which corresponds to the sum of the digits of the remaining unexpired term (years or months) of the policy, and the denominator, which remains constant, is the sum of all the years' (or months') digits corresponding to the entire term of insurance coverage. For example, if an insured debtor paid a $300 premium for disability benefits at the inception of a three-year single premium policy, he would be entitled to a refund under the Rule of 78 of $300 $\left(\frac{3+2+1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the first year, $150 $\left(\frac{2+1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the second year, and $50 $\left(\frac{1}{3+2+1}\text{X}\$300\right)$ if the policy was terminated at the beginning of the third year.

36. The unearned premium reserve for accident and health insurance is therefore 100 percent of the gross accident and health premium at the outset of a policy term. It is impossible for an insurance company to maintain such a reserve unless it has other funds besides the premium in question, since other

costs such as the agent's commission and administrative expenses must also be paid from the same premium. Even with other funds the restriction on capital imposed by such a reserve requirement is severe.

37. It has become customary in the industry to structure reinsurance treaties (which serve other valid business purposes of leveling the peaks and valleys in a particular company's liability pattern) in such a way that the larger, high-capital party to the treaty maintains the reserves required for any accident and health insurance involved. Thus the party whose capital can bear the burden of the restriction imposed by "unearned premium reserves" will physically hold those reserves and collect the investment income from them.

38. The result of plaintiff's treaties with American Bankers was that plaintiff was not required to maintain reserves for the accident and health insurance reinsured or written directly by it, to the extent said business was subject to those treaties.

39. In Treaty I, the accident and health insurance written by American Bankers was reinsured by plaintiff on a month-to-month basis, as it became "earned." The single premium received by American Bankers at the creation of the policy was held by American Bankers and remitted on a monthly basis, net of a 12½% retention, to plaintiff, as payment for the reinsurance being provided to American Bankers. American Bankers maintained the "unearned premium reserves" on said policies; plaintiff maintained no reserves. Plaintiff's obligation to reimburse American Bankers for insurance claims incurred was lim-

ited in the aggregate to the amount it received from American Bankers according to the treaty.

40. Plaintiff was not required by the state regulatory agencies to establish an unearned premium reserve with respect to its reinsurance of American Bankers' accident and health insurance policies under Treaty I because as of each payment from American Bankers to plaintiff, all such reinsurance premiums had been fully earned by plaintiff, and no portion of the reinsurance premiums received and held by plaintiff represented payment for insurance to be provided after the payment date.

41. Under Treaty II, plaintiff reinsured 80 percent (and later 65 percent) of the accident and health insurance, which it now wrote directly, with American Bankers. This reinsurance was not ceded on a month-to-month basis as earned, but all at once from the outset of the policy term. Plaintiff therefore remitted the entire premium, less commissions to agents, for the portion reinsured to American Bankers initially. American Bankers' obligation to reimburse plaintiff for insurance claims incurred was not limited in any way. American Bankers, holding the premiums, therefore established the reserves required for such insurance. Plaintiff established no such reserves.

42. Plaintiff was not required by any state regulatory agency to establish any unearned premium reserves as to insurance ceded by it to American Bankers under Treaty II because plaintiff held no unearned premiums on such policies, but instead received credit for reserves properly established by American Bankers, which did hold those premiums.

43. The unearned premiums and corresponding reserves in question under both treaties were physically held by American Bankers, which received the investment income therefrom, and which reported said reserves for purposes of state regulation as well as taxation. Plaintiff did not obtain or use the unearned premiums reflected in the annual statements of American Bankers, nor were said unearned premiums credited, set apart, or made available to plaintiff. There was no common or direct control of American Bankers by plaintiff or vice versa.

44. There was no existing state law which would have had the effect of "attributing" to plaintiff any reserves held by American Bankers on the insurance which was the subject of Treaties I and II. As unrelated parties to arms-length agreements, both plaintiff and American Bankers received benefits and gave consideration for said benefits under these treaties. The unearned premiums received by American Bankers were subject to no control or other proprietary interest on the part of plaintiff.

45. Under Treaty I, plaintiff had no obligation to refund premiums paid by policyholders of American Bankers in the event of premature termination of policies issued by American Bankers, since plaintiff received such premiums only after they had been fully earned. Consequently, there was no need, either legal or practical, for plaintiff to establish an unearned premium reserve for the purpose of maintaining a fund available for the refund of premiums.

46. Under Treaty II, since American Bankers received the accident and health premiums before they were earned, and since American Bankers' obligation to bear the cost of claims was not limited in any way, American Bankers properly maintained unearned premium reserves as to the portion of such policies reinsured.

47. The treaties in question and the method of maintaining reserves pursuant thereto were not unusual in the insurance industry at this time, and are still in use. The maintenance of said reserves was proper from an actuarial and an accounting point of view. It is standard in reinsurance accounting that the company which possesses the unearned premiums is the only company required to maintain the reserves thereon, unless one of the companies is not a qualified reinsurer.

48. The insurance industry is regulated by the states. A particular insurance company must meet the various industry requirements of its home state, and must satisfy the requirements of all states in which it is qualified to act as an insurer. The state requirements include standards for investments, maintenance of reserves, and accounting practices. The state insurance departments supervise policy forms, agency relationships, and the general financial activities of the companies within their jurisdictions. This regulation is designed to preserve the solvency of the insurance companies for the protection of policyholders.

49. To implement their regulatory function, state insurance departments require companies to file annual reports. Because reports are required in all states in which a company is qualified to act as an insurer, a standard report form has been developed by the National Association of Insurance Commissioners, which is used in all fifty states. These reports disclose, among other things, the reserves being maintained by each company.

50. In addition to requiring annual reports, the various state insurance departments conduct regular triennial examinations of insurance companies. Where the volume of business warrants it as to a particular company, it is customary for representatives of several state insurance departments to work together on these examinations. The examinations are carried out at the offices of the company in question, and may take as long as several months for large companies. Among the matters which are investigated in the course of such an examination are the reinsurance treaties to which a particular company is a party.

51. When a state insurance department is presented with a reinsurance agreement in existence between parties, its investigation will include a determination that each party has established adequate reserves according to its respective liabilities pursuant to the terms of the reinsurance agreement.

52. Plaintiff was the subject of triennial examinations in 1959 and 1963 by the insurance department of Arizona.

53. American Bankers was the subject of triennial examinations in 1960 and 1963. Participants in the 1960 examination were from the insurance departments of Florida, North Carolina, Georgia, and Texas; and participants in the 1963 examination were from the insurance departments of Florida, Georgia, Arizona, and Arkansas.

54. The reinsurance treaties between plaintiff and American Bankers were examined in detail in the course of the aforesaid examinations. The existence of reserves for accident and health insurance held by American Bankers on the policies covered by those treaties was clear to the examiners. Also the maintenance of the reserves by American Bankers under the treaties during Period I and Period II was approved in the course of the four examinations; no requirement or even suggestion was made in the examination reports that the reserves should be otherwise maintained.

55. There is no federal law pertaining to the matters of regulation which constitute the responsibility of the various states as described above.

56. Insofar as pertinent to this litigation, Treaty I read as follows:

ARTICLE I

American Bankers agrees to cede to *Consumer Life* and *Consumer Life* agrees to accept reinsurance to the extent set forth below:

One Hundred Per Cent (100%) of each and every Life policy and each and every Health and Accident policy (herein called "Life policies" and

"Health and Accident policies") issued by American Bankers in respect to debtors of *Consumer Life* and its subsidiary and affiliated corporations. The liability of *Consumer Life* under said Life and Health and Accident policies shall follow the liability of American Bankers except that the liability of *Consumer Life* arising under its reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable by *Consumer Life* under the provisions of Article V prior to the termination of this agreement.

ARTICLE II

This agreement applies to all said policies issued by American Bankers on or after the *1st* day of *July*, 1957.

ARTICLE III

American Bankers shall furnish *Consumer Life* on or before the 20th day of *July*, 1957 and on or before the 20th day of each month thereafter, a statement showing the following information on transactions of the preceding month:

A. On all Life policies the statement will show:

(1) The amount of premiums collected;
(2) The amount of premiums returned on account of cancellation or other reason; and
(3) The amount of losses paid.

B. On all Health and Accident policies the statement will show:

(1) The amount of premiums collected;

(2) The amount of premiums returned on account of cancellation or other reason;

(3) The amount of losses paid;

(4) The amount of losses reported and unpaid and the estimated amount of losses incurred and unreported at the end of the preceding month; and

(5) The amount of premiums earned.

For the purpose of computing premiums earned during any month on Health and Accident policies under this Article III, the sum of the premiums collected on policies written during the month less any premium returned because of cancellation or other reason during the month, shall be added to the unearned premium reserve at the beginning of the month on policies then in force, and from the total sum so obtained shall be subtracted the unearned premium reserve at the end of the month on policies in force at that time.

For the purpose of computing losses, losses reported and unpaid and losses incurred and unreported, the allocated loss expense shall be added to the amount of loss claims. In this connection the allocated loss expense shall be all claim expenses over and above the usual claim expenses incurred in the routine handling of a claim in the ordinary course of business, it being the intent of the parties hereto to include such expenses as the hiring of a special investigator, unusual travel expense in connection with the handling of a claim, attorney's fees arising from a claim and other expenses not incurred in the usual and ordinary course of handling a claim.

ARTICLE IV

In addition to the monthly statement set forth in Article III, American Bankers agrees to furnish *Consumer Life* on or before the 20th day of January each year and from time to time as may be requested by *Consumer Life*, but in no event more often than monthly, a statement containing the following information as at the end of the month preceding the statement:

A. The amount of reserve on all life policies then in force;

B. The amount of losses on Life policies reported and unpaid and the estimated amount of losses incurred but unreported;

C. The amounts of insurance on all Life policies;

D. Such other information as may be required to complete annual statements or other statements as required by law.

Consumer Life shall, at all reasonable times during this agreement, have full and free access to all books, records and files of American Bankers' office with respect to the business covered by this agreement.

ARTICLE V

In consideration of the reinsurance as set forth in Article I, the American Bankers agrees to pay monthly to *Consumer Life*, based on the statement set forth in Article III for the preceding month, and payable at the same time: (1) Eighty-seven and One-half Per Cent (87½%) of the premiums collected less any premiums returned on all Life policies, and (2) Eighty-seven

and One-half Per Cent (87½%) of the premiums earned on all Health and Accident policies.

Consumer Life agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted, for all losses actually paid during the preceding month on Life policies and all losses actually paid during the preceding month on Health and Accident policies plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

ARTICLE VI

American Bankers shall maintain all unearned premiums, loss and other reserves as may be required by law against all Health and Accident policies. *Consumer Life* shall maintain policy and other reserves as may be required by law on all Life policies.

ARTICLE VII

American Bankers agrees to pay all state, county, or city taxes which may be or become due in connection with the insurance sold or premiums collected on policies reinsured under this agreement.

ARTICLE VIII

American Bankers has furnished to *Consumer Life* and *Consumer Life* has acknowledged having received from American Bankers specimen forms upon which all said policies covered hereby

are currently written. American Bankers reserves the right to make changes in such forms from time to time, but shall promptly notify *Consumer Life* of all such changes.

ARTICLE IX

The supervision and payment of all claims on policies covered by this agreement shall be handled by American Bankers and the decision of American Bankers in settling, rejecting or defending such claims shall be binding on *Consumer Life.*

ARTICLE X

In the event of the insolvency of the American Bankers, all reinsurance shall be payable directly to the liquidator, receiver or statutory successor of said American Bankers, without diminution because of the insolvency of American Bankers.

In the event of insolvency of American Bankers, the liquidator, receiver or statutory successor shall give *Consumer Life* written notice of the pendency of a claim on the policy reinsured within a reasonable time after such claim is filed in the insolvency proceeding. During the pendency of any such claim, *Consumer Life* may investigate such claim and interpose in the name of American Bankers (its liquidator, receiver or statutory successor,) but at its own expense, in the proceeding where such claims are to be adjudicated, any defense or defenses which *Consumer Life* may deem available to American Bankers or its liquidator, receiver or statutory successor.

ARTICLE XI

All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the agreement obligation.

The court of arbitrators which is to be held in the city of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this agreement. One of the arbitrators is to be appointed by American Bankers, the second by *Consumer Life* and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the president of the American Life Convention.

The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

This agreement constitutes the entire contract between the parties and may not be altered, modified or in any ways amended except by an instrument in writing duly executed by the proper official of both parties.

ARTICLE XIII

This agreement may be terminated by either party effective on the last day of any month upon at least thirty (30) days written notice of the other party.

Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be signed and sealed by their duly authorized officers on this *28* day of *June*, 1957.

57. By amendments effective November 1, 1957 and April 1, 1958, American Bankers' retained share of the total premiums received annually in excess of $200,000 was reduced from 12½ percent, as provided in Article V of Treaty I, finding 56, *supra*, to 9½ percent.

58. Treaty I was further amended May 28, 1958, effective as of July 1, 1957, to revise the extent of plaintiff's interim liability as the reinsurer of American Bankers' exposure under the A & H coverages subject to the Treaty. At all times, however, plaintiff reinsured the entire risk represented by those coverages, the only change being in the timing of its loss indemnity payments to American Bankers. At the time of this amendment plaintiff had accumulated a surplus fund of $130,000 from A & H pre-

mium receipts out of which to meet its reinsurance obligations which were averaging approximately $3,000 per month.

59. Treaty II is recited in toto. It read as follows:

ARTICLE I

Basis of Reinsurance

1. On and after the effective date hereof, the Ceding Company's liability under Credit Accident and Sickness policies issued directly by the Ceding Company on the policy forms specified in Schedule A, attached hereto, shall be reinsured automatically to the degree and in the manner hereinafter specified.

2. The reinsurance liability of American Bankers during 1962 shall be 80% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the ceding company at the beginning of each subsequent calendar year.

3. Reinsurance hereunder shall apply and be subject to all benefits and limitations included in policies issued by the Ceding Company and subject to reinsurance hereunder.

ARTICLE II

Mode of Cession

1. Reinsurance of Credit Accident and Sickness insurance issued or renewed by the Ceding Company on and after the effective date of this Agreement shall be effected by the Ceding Com-

pany's mailing to American Bankers a reinsurance cession on a form of which a sample is attached hereto and marked Schedule B, not later than the twentieth day following the last day of the calendar quarter covered by the reinsurance cession. The liability of American Bankers shall:

(a) commence as of the effective dates of the reinsurance premiums, and

(b) continue only for the period covered by the reinsurance premiums.

2. In no event shall the reinsurance be in force and binding unless the policy issued by the Ceding Company to the insured is in force.

ARTICLE III

Reinsurance Premiums

1. The reinsurance premiums to be paid the American Bankers by the Ceding Company shall be the premiums charged the insured by the Ceding Company during the calendar quarter for the coverage reinsured.

2. American Bankers will pay to the Ceding Company a commission of 50% of reinsurance premiums received, as specified in this Article, on reinsurance hereunder.

ARTICLE IV

Oversights

1. American Bankers shall be bound as the Ceding Company is bound, and it is expressly understood and agreed that if non-payment of premiums within the time specified or failure to

comply with the terms of this Agreement is shown to be unintentional and the result of misunderstanding or oversight on the part of either the Ceding Company or American Bankers, both the Ceding Company and American Bankers shall be restored to the positions they would have occupied had no such error or oversight occurred.

ARTICLE V

Payment of Claims

1. At the end of each calendar quarter American Bankers shall reimburse the Ceding Company for American Bankers share of all claim payments made by the Ceding Company during the calendar quarter on policies reinsured hereunder.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

ARTICLE VI

Experience Refunds

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl)

where P = earned reinsurance premiums during the calendar quarters as determined by American Bankers.

Co = earned reinsurance commission during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

2. If P-Co-E-Cl is negative for a given calendar quarter such negative amount will be treated as an addition to the incurred claims in calculating the Experience Refund for the following calendar quarters.

ARTICLE VII

Taxes, Assessments and Expenses

Neither party hereto shall be liable to the other for taxes, assessments, or any expenses resulting from reinsurance hereunder. The Ceding Company shall furnish the American Bankers with all necessary information so that American Bankers will not be required to perform any office work other than the regular bookkeeping entries made in connection with reinsurance accounting.

ARTICLE VIII

Inspection of Records

American Bankers shall have the right at any reasonable time to inspect at the office of the Ceding Company all books and documents relating to the reinsurance under this Agreement.

ARTICLE IX

Insolvency

1. In the event of insolvency of the Ceding Company, all reinsurance in force shall be payable to its liquidator or receiver without diminution because of the insolvency of the Ceding Company by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is understood, however, that in the event of the insolvency of the Ceding Company, the liquidator, receiver or statutory successor of the Ceding Company shall give written notice of the pendency of a claim against the Ceding Company on the policy reinsured with[in] a reasonable time after such claim is filed in the insolvency proceedings and that during the pendency of such claim the American Bankers may investigate such claim and interpose, at its own expense, in the proceedings where such claim is to be adjudicated any defense or defenses which it may deem available to the Ceding Company or its liquidators or receiver or statutory successor.

2. The expense thus incurred by American Bankers shall be chargeable against the Ceding Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Ceding Company solely as a result of the defense undertaken by American Bankers.

ARTICLE X

Settlement of Claims

1. American Bankers shall be liable to the Ceding Company for the benefits covered by reinsurance hereunder to the same extent as the Ceding Company is liable to the insured for such benefits and all reinsurance shall be subject to the terms and conditions of the particular form of policy under which the Ceding Company shall be liable.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

3. Whenever a claim is made under a policy of the Ceding Company, which has been reinsured hereunder, it shall be taken and considered by American Bankers to be a claim for the amount of reinsurance on such risk and American Bankers shall abide the issue as it shall be settled by the Ceding Company and shall pay the amount of reinsurance covered by the policy of reinsurance when the Ceding Company shall settle with the Claimant.

4. Any suit or claim may be contested or compromised on the part of the Ceding Company and in case of a reduction of the claim made upon the Ceding Company, American Bankers and the Ceding Company shall participate in such reduction in the ratio that each company's net liability bore to the total net liability prior to the reduction of the claim. Any unusual expenses incurred by the Ceding Company in defending or investigating any claims or taking

up or rescinding any policy reinsured hereunder aside from routine investigations and other expenses incidental to the settlement of claims shall be shared in the same proportion.

5. In every case of loss, copies of proofs obtained by the Ceding Company shall likewise be taken as sufficient by American Bankers and copies thereof, together with a statement showing the amount paid on such claim by the Ceding Company shall be furnished to American Bankers before payment shall be demanded of it.

ARTICLE XI

Arbitration

1. All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this treaty from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitrators which is to be held in the City of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this Agreement. One of the arbitrators is to be appointed by the Ceding Company, the second by American Bankers and the third is to be selected by those two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the

choice of a third, the appointment shall be left to the counsel for the Consumer Credit Insurors Association.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE XII

Parties to Agreement

This is an agreement solely between the Ceding Company and American Bankers. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Bankers and the insured or the beneficiary under any policy of the Ceding Company which may be reinsured hereunder.

ARTICLE XIII

Duration

1. This agreement shall be effective as of the 1st day of March 1962, and may be terminated as of the end of any calendar quarter by either party giving to the other not less than 30 days' written notice.

2. Upon termination, as provided in this Article, the Ceding Company shall, within 30 days of the termination date, supply American Bankers with the information necessary to calculate the final experience refund as of the termination date. Payment of (a) the final experience re-

fund, (b) the unearned premium reserve held by American Bankers less unearned commissions thereon, and (c) payment of the claim reserve held by American Bankers.

60. On December 2, 1964, effective October 1, 1964, plaintiff and American Bankers executed the following amendment to Treaty II:

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 2nd day of December, 1964, and effective the 1st day of October, 1964, by and between CONSUMER LIFE INSURANCE COMPANY OF PHOENIX, ARIZONA, hereinafter designated as "Ceding Company" and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami, and State of Florida, hereinafter designated as "Company".

WITNESSETH:

WHEREAS, the Company and the Ceding Company entered into a Reinsurance Agreement on the 1st day of March, 1962; and

WHEREAS, the parties are mutually desirious of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I, Paragraph (2) is hereby amended to read:

> The reinsurance liability of American Bankers shall be 65% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the Ceding Company at the beginning of each subsequent calendar year.

3. All other conditions are to remain the same.

61. On December 29, 1964, effective December 31, 1964, plaintiff and American Bankers executed the following further amendment to Treaty II:

AMENDMENT TO Reinsurance Agreement between Consumer Life Insurance Company of Phoenix, Arizona, and American Bankers Life Assurance Company of Florida, of Miami, Florida, dated April 18, 1962.

Article VI of above mentioned Reinsurance Agreement is hereby amended to read as follows:

ARTICLE VI

Experience Refunds

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P-Co-E-Cl-N)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

N = negative carry-forward from prior quarter.

2. If a negative amount is obtained from the calculation of the Experience Refund for a given calendar quarter, such negative amount will be carried forward in calculating the Experience Refund for the following calendar quarter, provided, however, that any unamortized balance of such negative carry-forward will be dropped from the refund calculation after 20 quarters. The "first-in, first-out" principle will apply to the unamortization of two or more negative carry-forwards arising from the experience of different calendar quarters.

IN WITNESS WHEREOF the parties hereto have caused this Amendment to be executed in duplicate this 29th day of December, 1964, and to be effective for calculating the Experience Refund due for the calendar quarter ending December 31, 1964.

ULTIMATE CONCLUSION OF FACT

62. Unearned premiums and the corresponding reserves held pursuant to Treaty I are not includable in plaintiff's "total reserves" for purposes of Internal Revenue Code Section 801.

63. Unearned premiums and the corresponding reserves held pursuant to Treaty II are not includabel in plaintiff's "total reserves" for purposes of Internal Revenue Code Section 801.

64. Plaintiff qualified as a life insurance company for purposes of Section 801 because its life insurance reserves exceeded 50 percent of its total reserves, as that term is defined in Section 801(c), as shown by plaintiff's income tax returns for the years 1958, 1959, 1960, 1962, 1963, and 1964.

CONCLUSION OF LAW

Upon the foregoing opinion and findings of fact, which are made a part thereof, the court concludes as a matter of law that plaintiff is entitled to recover; and judgment is entered to that effect, with the determination of the amount of recovery to be made in further proceedings under Rule 131(c).

☆ U. S. GOVERNMENT PRINTING OFFICE: 1978 200295 201

Supreme Court, U. S.
FILED
JUL 28 1976
MICHAEL RODAK, JR., CLERK

APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA,

Petitioner

—v.—

CONSUMER LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION FOR A WRIT OF CERTIORARI FILED FEBRUARY 25, 1976
CERTIORARI GRANTED MAY 24, 1976

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA,

Petitioner

—*v.*—

CONSUMER LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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GENERAL DOCKET

Case No. 463-70

CONSUMER LIFE INSURANCE COMPANY

vs.

THE UNITED STATES

DOCKET ENTRIES

DATE	PROCEEDINGS
Dec. 30, 1970	Filing fee of $10 paid by plaintiff.
Dec. 31, 1970	Court filed order referring case to Commissioner George Willi.
Feb. 25, 1971	Defendant's motion for extension of time (to April 29, 1971) to file its answer filed. Copies (2) to atty. ALLOWED MAR. 16, 1971.
Apr. 23, 1971	Defendant's answer to the petition filed. Copies (13) to atty.
Apr. 26, 1971	Commissioner's standard pretrial order on liability filed. Copy to parties.
Jun. 7, 1971	Plaintiff's motion for extension of time (to August 9, 1971) to comply with pretrial order filed. Copies (2) to deft. ALLOWED JUNE 8, 1971.
Sep. 30, 1971	Defendant's motion for leave to file out of time a motion for extension of time filed. Copies (2) to atty. ALLOWED OCT. 19, 1971.
Oct. 19, 1971	Defendant's extension of time (to November 22, 1971) to comply with pretrial order filed. Copies (2) to atty. ALLOWED NOV. 4, 1971.
Nov. 18, 1971	Defendant's motion for extension of time (to December 22, 1971) to comply with pretrial order filed. Copies (2) to atty. ALLOWED DEC 6 1971.

DATE	PROCEEDINGS

Mar. 23, 1973 Commissioner's memorandum and order under Rule 113 filed. Copy to parties.

Dec. 3, 1973 Transcript of testimony (2 volumes plus a master index—471 pages) taken at Atlanta, Georgia on July 17 & 18, 1973 together with plaintiff's exhibits 1 thru 6, 7a-f, 8a-d, 9a-h, 10, 11, 12a-c, 13a-c, 14, 15a-c, 16 thru 27 and defendant's exhibits 1 thru 8 filed. Notice to parties.

Dec. 3, 1973 Trial judge's order closing proof, etc. filed. Copy to parties.

Dec. 26, 1973 Plaintiff's motion for extension of time (to February 6, 1974) to file requested findings, etc. filed. Copies (2) to deft. ALLOWED DEC 28 1973.

Feb. 4, 1974 Plaintiff's requested findings of fact and Plaintiff's brief filed. Copies (2 of each) to deft.

Mar. 5, 1974 Defendant's motion for extension of time (to April 20, 1974) to file requested findings, etc. filed. Copies (2) to atty. ALLOWED MAR 6 1974.

Apr. 19, 1974 Defendant's motion for extension of time (to May 11, 1974) to file requested findings, etc. filed. Copies (2) to atty. ALLOWED APR 23.

May 13, 1974 Defendant's objections to requested findings of fact, defendant's requested findings of fact and defendant's brief to the trial judge filed. Copies (2) of each to atty.

Jun. 3, 1974 Plaintiff's motion for extension of time (to June 27, 1974) to file its reply brief, etc. filed. Copies (2) to deft. ALLOWED JUN 4 1974.

Jun. 26, 1974 Plaintiff's objections to defendant's requested findings of fact filed. Copies (2) to deft.

Jun. 26, 1974 Plaintiff's reply brief to the Trial Judge filed. Copies (2) to deft.

Dec. 13, 1974 Trial judge's opinion and findings of fact filed. Copies to parties.

DATE	PROCEEDINGS

Jan. 15, 1975 Plaintiff's notice of intention to except to commissioner's report filed. Copies (2) to deft.

Feb. 3, 1975 Plaintiff's motion for extension of time (to March 5, 1975) to file exceptions and brief filed. Copies (2) to deft ALLOWED FEB 4 1975.

Mar. 10, 1975 Plaintiff's exceptions to trial judge's findings of fact, etc. filed. Copies (5) to deft.

Mar. 10, 1975 Plaintiff's brief accompanying exceptions filed. Copies (5) to deft.

Mar. 12, 1975 Court entered order that this case shall be heard en banc by the court at the June 1975 session of the court. Copies (3) to parties.

Apr. 8, 1975 Defendant's motion for extension of time (to April 24, 1975) to file its brief filed. Copies (2) to atty. ALLOWED APR 9 1975, with no further extension to be granted.

Apr. 24, 1975 Defendant's brief filed. Copies (5) to atty.

May 6, 1975 Motion by Penn Security Life Insurance Company to participate as amicus curiae [in the oral argument] filed. Copy to parties. MAY 7 1975: Motion GRANTED provided *Penn Security* shall not be allowed any oral argument if the court finds, as presently indicated by the briefs, that no new and significant issues are raised in the oral argument in No. 463-70.

May 19, 1975 Plaintiff's reply brief filed. Copies (5) to deft.

Jun. 6, 1975 Argued and submitted on the merits [before Cowen, Laramore & Skelton].

Jun. 13, 1975 Defendant's motion for leave to advice court of the opinion in First Railroad & Banking Company of Georgia v. United States filed. Copies (2) to atty. ALLOWED JUN 16 1975.

DATE	PROCEEDINGS
Jul. 14, 1975	Plaintiff's motion for leave to advise the court of a petition for rehearing, etc. filed. Copies (2) to deft. ALLOWED JUL 25 1975.
Oct. 22, 1975	Judgment for plaintiff with the amount of recovery to be determined pursuant to Rule 131 (c). Opinion by Judge Kashiwa. Dissenting opinion by Judge Nichols.
Mar. 3, 1976	Notice of filing, by defendant, in Supreme Court of a petition for writ of certiorari, on February 25, 1976, No. 75-1221, filed.
May 27, 1976	Order of the Supreme Court, dated May 24, 1976, allowing certiorari filed. Notice to trial judge.
May 27, 1976	Record in re certiorari forwarded to Supreme Court.

IN THE
UNITED STATES COURT OF CLAIMS

No. 463-70

CONSUMER LIFE INSURANCE CO., PLAINTIFF,

v.

UNITED STATES OF AMERICA, DEFENDANT.

(Filed: December 30, 1970)

PETITION

Count I

1. Plaintiff herein is a stock insurance company organized and existing under the laws of the State of Arizona with its executive offices located in Atlanta, Georgia.

2. This is a civil action for the recovery of income taxes and interest erroneously overpaid and collected under the Internal Revenue Code of 1954 (hereinafter referred to as the "Code") and jurisdiction of this Court is invoked pursuant to Title 28, U.S.C. § 1346(a)(1).

3. This count of this petition is brought for the recovery of the overpayment of federal income taxes and interest in the amount of $86,804.47 for the taxable year ended December 31, 1958, $120,275.60 for the taxable year ended December 31, 1959, $82,746.88 for the taxable year ended December 31, 1960, $461.88 for the taxable year ended December 31, 1962, $38,479.61 for the taxable year ended December 31, 1963, $22,625.44 for the taxable year ended December 31, 1964, plus interest as allowed by law.

4. Under date of February 20, 1969, the District Director of Internal Revenue, Atlanta, Georgia (hereinafter referred to as "District Director") sent Plaintiff a notice of deficiencies in federal income taxes in the aggregate amount of $235,762.75, plus interest, for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963 and

1964. The statement accompanying said notice of deficiency set forth the reasons for the alleged deficiencies in federal income taxes as follows:

> "It is determined that for your taxable years 1958, 1959, 1960, 1962, 1963 and 1964, you did not qualify as a life insurance company within the meaning of section 801 of the Internal Revenue Code of 1954, entitling you to taxation under section 802 of the 1954 Code. Consequently, your taxable income is being computed under section 832 of the 1954 Code. This determination is based on the following:
>
> "(1) You did not compute or estimate your life insurance reserves on credit life contracts on the basis of a recognized Mortality Table and assumed rates of interest, as required by section 801(b) of the 1954 Code, and/or
>
> "(2) You did not reflect in your total reserves, defined in section 801(c) of the 1954 Code certain unearned premiums on accident and health contracts under certain reinsurance agreements which should have been included therein. Accordingly, when your total reserves are corrected, your life insurance reserves as reported, even if recognized as having been computed or estimated on a basis of a recognized mortality table, would not exceed 50% of your correct total reserves pursuant to section 801(a) of 1954 Code."

5. On or about July 30, 1969, Plaintiff paid to the District Director the aggregate amount of $351,393.88 additional federal income taxes and interest thereon for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963 and 1964.

6. For each of the taxable years in question, Plaintiff filed timely federal income tax returns and paid all income taxes shown due on each such return.

7. On or about October 14, 1969, Plaintiff filed with the District Director Claims for Refund for the overpayment of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above. On or about June 26, 1970, Plaintiff filed amended

Claims for Refund for the overpayment of taxes and interest in the respective amounts and for each of the taxable years as described in paragraph 3 above. Copies of such amended Claims for Refund are attached hereto as Exhibit A and made a part hereof.

8. On or about October 27, 1970, the District Director notified Plaintiff that the aforesaid amended Claims for Refund for the overpayment of taxes and interest had been disallowed.

9. Plaintiff has overpaid its federal income taxes for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963 and 1964.

10. During each of the taxable years in question, Plaintiff was a "life insurance company," as defined in Section 801(a) of the Code, and its life insurance reserves, as defined in Section 801(b) of the Code, plus unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprised more than fifty percent of its total reserves, as defined in Section 801(c).

11. Plaintiff's life insurance reserves were computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, were set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance and noncancellable health and accident insurance contracts involving, at the time with respect to which the reserve was computed, life, health, or accident contingencies, and were required by law.

12. The District Director erroneously increased Plaintiff's total reserves, as defined in Section 801(c) of the Code, by including in such total reserves the total unearned premiums on certain health and accident insurance contracts as herein described.

13. During the taxable years ended December 31, 1958, 1959 and 1960, Plaintiff was a party to a Reinsurance Agreement with American Bankers Life Assurance Company (hereinafter referred to as "American Bankers"), pursuant to which Plaintiff agreed to reinsure, in the manner described in such Reinsurance Agreement, each

and every life insurance policy and each and every health and accident insurance policy written by American Bankers in respect to debtors of Southern Discount Company, the Plaintiff's parent company, and its subsidiaries, which companies were primarily engaged in the business of consumer finance. The said Reinsurance Agreement between Plaintiff and American Bankers provided that the liability of Plaintiff on the life insurance policies and health and accident insurance policies shall follow the liability of American Bankers; except that the liability arising under the reinsurance of health and accident policies would be on a month-to-month basis only and Plaintiff's liability was limited solely to the amount payable by American Bankers to Plaintiff under the terms of the Reinsurance Agreement, which amount constituted the monthly earned portion of the total premiums.

14. For the taxable years 1958, 1959 and 1960, Plaintiff did not establish and maintain unearned premium reserves with respect to such health and accident insurance reinsured by Plaintiff, and pursuant to the laws of the State of Arizona Plaintiff was not required to maintain the unearned premium reserves with respect to such health and accident insurance.

15. For the taxable years 1962, 1963 and 1964, Plaintiff issued combined life insurance and health and accident insurance policies in certain states to debtors of Southern Discount Company and certain of its subsidiaries. During such taxable years, Plaintiff was a party to a Reinsurance Agreement with American Bankers pursuant to which American Bankers agreed to reinsure a portion of such health and accident insurance written by Plaintiff.

16. Plaintiff did not establish and maintain unearned premium reserves with respect to that portion of the health and accident insurance so reinsured by Plaintiff with American Bankers, and pursuant to the laws of the State of Arizona Plaintiff was not required to maintain the unearned premium reserves with respect to such health and accident insurance.

17. The Reinsurance Agreements between Plaintiff and American Bankers were negotiated at arm's length, and the Reinsurance Agreements were entered into for valid business purposes and had economic significance to both parties thereto.

18. The unearned premiums with respect to the health and accident insurance written by American Bankers for the taxable years 1958 through 1960, and the health and accident insurance written by Plaintiff for the taxable years 1962 through 1964, a portion of which was reinsured with American Bankers, should not be included in Plaintiff's "total reserves" within the meaning of Section 801(c) of the Code.

19. The District Director erroneously determined that the Plaintiff did not qualify as a "life insurance company" within the meaning of Section 801 of the Code and the District Director erroneously determined that the Plaintiff was not entitled to taxation pursuant to Section 802 of the Code. The District Director erroneously determined that the Plaintiff did not compute or estimate its life insurance reserves on the basis of recognized mortality or morbidity tables and assumed rates of interest. The District Director erroneously determined that Plaintiff should include in its total reserves, as defined in Section 801(c) of the Code, unearned premiums on health and accident insurance contracts which were the subject of Reinsurance Agreements between Plaintiff and American Bankers.

20. The District Director erroneously disallowed Plaintiff's Claims for Refund and such additional taxes and interest paid thereon should be refunded to Plaintiff.

WHEREFORE, Plaintiff prays that it be given judgment against the Defendant in the amount of $351,393.88, plus interest as allowed by law, or such greater amount as may be legally refundable, plus costs of this action and such other relief as this Court may deem just and equitable.

Count II

This Count sets forth an alternative claim in the event it is held that the District Director was correct in determining that Plaintiff should establish and maintain reserves with respect to the health and accident insurance which was the subject of the Reinsurance Agreements between Plaintiff and American Bankers.

1.-10. Paragraphs 1 through 10 of Count I are incorporated in this Count II as paragraphs 1 through 10 respectively.

11.-12. Paragraphs 13 and 15 of Count I are incorporated in this Count II as paragraphs 11 and 12 respectively.

13. Such health and accident insurance was written in a single policy with the life insurance which was also sold to the insureds. The policies of life insurance were noncancellable, and the life insurance benefit was coterminous with the health and accident insurance benefit and both benefits were combined in a single policy.

14. The reserves with respect to such health and accident insurance would be includable in the computation of Plaintiff's "life insurance reserves" in that such amounts were computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and were set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity and noncancellable health and accident insurance contracts (including life insurance contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

15. Such health and accident insurance was noncancellable and the unearned premium reserve established with respect to such noncancellable health and accident insurance would be includable in the computation of unearned premiums, and unpaid losses (whether or not ascertained) on noncancellable life, health or accident policies not included in life insurance reserves, as described in Section 801(a)(2) of the Code.

16. The District Director erroneously determined that Plaintiff did not qualify as a "life insurance company" within the meaning of Section 801 of the Code, and the District Director erroneously determined that Plaintiff was not entitled to taxation under Section 802 of the Code.

17. The District Director erroneously disallowed Plaintiff's Claims for Refund and such additional taxes and interest paid thereon should be refunded to Plaintiff.

WHEREFORE, Plaintiff prays that it be given judgment against the Defendant in the amount of $351,393.88, plus interest as allowed by law, or such greater amount as may be legally refundable, plus costs of this action and such other relief as this Court may deem just and equitable.

Count III

This Count sets forth an alternative claim in the event it is held that the District Director was correct in determining that Plaintiff should establish and maintain reserves with respect to the health and accident insurance which was the subject of the Reinsurance Agreements between Plaintiff and American Bankers, and in the event it is held that such reserves do not qualify as "life insurance reserves."

1.-10. Paragraphs 1 through 10 of Count I are incorporated in this Count III as paragraphs 1 through 10 respectively.

11.-12. Paragraphs 13 and 15 of Count I are incorporated in this Count III as paragraphs 11 and 12 respectively.

13. The Reinsurance Agreement that was in effect between Plaintiff and American Bankers for the taxable years 1958, 1959 and 1960, provided for monthly premium payments from American Bankers to Plaintiff. Any excess premium payments over the amount of monthly premiums required to be remitted pursuant to the terms of the contract would be premiums paid in advance of the due date. Such premiums paid in advance would not

be unearned premiums and would not be included in the computation of the amount of "total reserves" as defined in Section 801(c) of the Code.

14. Plaintiff's total reserves, as defined in Section 801(c) of the Code, would not include any amounts relating to advance premiums, and Plaintiff's life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies would comprise more than fifty percent of Plaintiff's total reserves.

15. The Reinsurance Agreement that was in effect between Plaintiff and American Bankers for the taxable years 1962, 1963 and 1964, provided for Plaintiff to remit to American Bankers a percentage of the single premium for each policy reinsured with American Bankers at the end of the quarter with respect to which such premiums were collected. Any premiums not remitted to American Bankers in accordance with the terms of the Reinsurance Agreements would constitute a liability from Plaintiff to American Bankers and not unearned premiums.

16. Plaintiff's total reserves, as defined in Section 801(c) of the Code, would not include any amounts relating to premiums which were not remitted to American Bankers in accordance with the terms of the Reinsurance Agreements, and the Plaintiff's life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies would comprise more than fifty percent of Plaintiff's total reserves.

17. In computing the amount of "total reserves" as defined in Section 801(c) of the Code, the District Director erred in determining the cost of carrying the insurance risk.

18. The District Director erred in failing to include in the calculation of unearned premiums and unpaid losses, as defined in Section 801(a)(2) of the Code, the amount of unpaid losses on noncancellable life insurance contracts.

19. The District Director erroneously determined that Plaintiff did not qualify as a "life insurance company" within the meaning of Section 801 of the Code, and the District Director erroneously determined that the Plain-

tiff was not entitled to taxation under Section 802 of the Code.

20. The District Director erroneously disallowed Plaintiff's Claims for Refund and such additional taxes and interest paid thereon should be refunded to Plaintiff.

WHEREFORE, Plaintiff prays that it be given judgment against the Defendant in the amount of $351,393.88, plus interest as allowed by law, or such greater amount as may be legally refundable, plus costs of this action and such other relief as this Court may deem just and equitable.

E. Michael Masinter
Attorney for Plaintiff

Hansell, Post, Brandon & Dorsey
3300 First National Bank Tower
Atlanta, Georgia 30303
(404) 522-3558

Of Counsel.

Hansell, Post, Brandon & Dorsey
3300 First National Bank Tower
Atlanta, Georgia 30303

Plaintiff's Post Office Address:

Consumer Life Insurance Co.
919 West Peachtree Street, N. E.
Atlanta, Georgia 30309

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Nov. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps
CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.
City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number | Wife's number, if joint return | b. Employer identification number (if any): 58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1, 1958, to December 31, 1958

f. Kind of tax: Income Tax and Interest

g. Amount of assessment: $ 86,804.47

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below): $ 86,804.47 *

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons:

* Plus interest allowed by law.

** Amount from Line 9 below	53,683.33
Interest assessed through 6-27-69	33,121.14
Total to g. and i. above	86,804.47

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	48,144.32
4 Any additional income tax paid	53,683.33
5 Total tax paid (add lines 1–4)	101,827.65
6 Less: Your computation of correct tax	48,144.32
7 Amount of overpayment	53,683.33
8 Amount previously refunded	
9 Net overpayment (enter in Item i above)	53,683.33 **

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: D. W. Bacon V.P. & Treas.

Dated June 25, 1970

SEE INSTRUCTIONS ON REVERSE — Form 843 (Rev. 11-68)

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Nov. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps
CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.
City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number | Wife's number, if joint return | b. Employer identification number (if any): 58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1, 1959, to December 31, 1959

f. Kind of tax: Income Tax and Interest

g. Amount of assessment: $ 120,275.60

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below): $ 120,275.60 *

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons:

* Plus interest allowed by law.

** Amount from Line 9 below	77,249.66
Interest assessed to 6-27-69	43,025.94
Total to g. and i. above	120,275.60

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	72,405.55
4 Any additional income tax paid	77,249.66
5 Total tax paid (add lines 1–4)	149,655.21
6 Less: Your computation of correct tax	72,405.55
7 Amount of overpayment	77,249.66
8 Amount previously refunded	
9 Net overpayment (enter in Item i above)	77,249.66**

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: D. W. Bacon V.P. & Treas.

Dated June 25, 1970

SEE INSTRUCTIONS ON REVERSE — Form 843 (Rev. 11-68)

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Nov. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

a. Name of taxpayer or purchaser of stamps: CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.

City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number | Wife's number, if joint return | b. Employer identification number (if any): 58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above:

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1 19 60 to December 31 19 60

f. Kind of tax: Income Tax and Interest

g. Amount of assessment: $ 82,746.88

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government:

i. Amount to be refunded (if income tax, complete computation below): $ 82,746.88*

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons: See statement attached

* Plus interest allowed by law.

** Amount from Line 9 below	55,276.15
Interest assessed through 6-27-69	27,470.73
Total to g. and i. above	$82,746.88

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	52,377.05
4 Any additional income tax paid	55,276.15
5 Total tax paid (add lines 1–4)	107,653.20
6 Less: Your computation of correct tax	52,377.05
7 Amount of overpayment	55,276.15
8 Amount previously refunded	
9 Net overpayment (enter in item I above)	55,276.15**

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: J. W. Bowen V. Pres.

Dated June 25, 1970

SEE INSTRUCTIONS ON REVERSE Form 843 (Rev. 11-68)

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Nov. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

a. Name of taxpayer or purchaser of stamps: CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.

City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number | Wife's number, if joint return | b. Employer identification number (if any): 58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above:

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1 19 62 to December 31 19 62

f. Kind of tax: Income Tax and Interest

g. Amount of assessment: $ 461.88

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government:

i. Amount to be refunded (if income tax, complete computation below): $ 461.88*

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons: See statement attached.

* Plus interest allowed by law.

** Amount from Line 9 below	335.43
Interest assessed through 6-27-69	126.45
Total to g. and i. above	$461.88

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	17,047.52
4 Any additional income tax paid	335.43
5 Total tax paid (add lines 1–4)	17,382.95
6 Less: Your computation of correct tax	17,047.52
7 Amount of overpayment	335.43
8 Amount previously refunded	
9 Net overpayment (enter in item I above)	335.43**

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: J. W. Bowen V. Pres.

Dated June 25, 1970

SEE INSTRUCTIONS ON REVERSE Form 843 (Rev. 11-68)

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Dec. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps: CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.

City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number	Wife's number, if joint return	b. Employer identification number (if any)
		58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above:

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1, 1963, to December 31, 1963

f. Kind of tax:

g. Amount of assessment: $ 38,479.61

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government:

i. Amount to be refunded (If income tax, complete computation below): $ 38,479.61*

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons: See statement attached

*Plus interest allowed by law.

**Amount from Line 9 below	29,218.23
Interest assessed through 6-27-69	9,261.38
Total to g. and i. above	$38,479.61

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	43,790.32
4 Any additional income tax paid	29,218.23
5 Total tax paid (add lines 1–4)	73,008.55
6 Less: Your computation of correct tax	43,790.32
7 Amount of overpayment	29,218.23
8 Amount previously refunded	
9 Net overpayment (enter in item I above)	29,218.23**

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: J. W. Barry V.P. & Treas.

Dated: June 25, 1970

SEE INSTRUCTIONS ON REVERSE — Form 843 (Rev. 11-68)

EXHIBIT A

AMENDED CLAIM FOR REFUND

Form 843 (Rev. Dec. 1968) Department of the Treasury Internal Revenue Service

Claim

Director's Stamp (Date received)

The Internal Revenue Service will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to income, estate or gift taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps: CONSUMER LIFE INSURANCE CO.

Number and street: 919 West Peachtree Street, N. E.

City or town, State, and ZIP code: Atlanta, Georgia 30309

Fill in applicable items—Use attachments if necessary

a. Your social security number	Wife's number, if joint return	b. Employer identification number (if any)
		58-0825266

c. Internal Revenue Service office where return (if any) was filed: Phoenix, Arizona

d. Name and address shown on return, if different from above:

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year: From January 1, 1964, to December 31, 1964

f. Kind of tax: Income Tax and Interest

g. Amount of assessment: $ 22,625.44

Dates of payment: July 30, 1969

h. Date stamps were purchased from Government:

i. Amount to be refunded (If income tax, complete computation below): $ 22,625.44*

j. Amount to be abated (not applicable to income, estate, or gift taxes): $

k. The claimant believes that this claim should be allowed for the following reasons: See statement attached.

*Plus interest allowed by law.

**Amount from Line 9 below	17,999.95
Interest assessed through 6-27-69	4,625.49
Total to g. and i. above	22,625.44

COMPUTATION OF INCOME TAX REFUND	Income Tax
1 Tax withheld	
2 Estimated tax paid	
3 Tax paid with original return	17,726.51
4 Any additional income tax paid	17,999.95
5 Total tax paid (add lines 1–4)	35,726.46
6 Less: Your computation of correct tax	17,726.51
7 Amount of overpayment	17,999.95
8 Amount previously refunded	
9 Net overpayment (enter in item I above)	17,999.95**

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed: J. W. Barry V.P. & Treas.

Dated: June 25, 1970

SEE INSTRUCTIONS ON REVERSE — Form 843 (Rev. 11-68)

EXHIBIT A

CLAIM FOR REFUND

Consumer Life Insurance Co. (hereinafter referred to as "Taxpayer") is a stock insurance company organized and existing under the laws of the State of Arizona. Taxpayer is engaged in the life insurance and health and accident insurance business. Taxpayer's home office is located at 222 North Central Avenue, Suite 904, Phoenix, Arizona, 85004, and Taxpayer's executive offices are located at 919 West Peachtree Street, N. W., Atlanta, Georgia, 30309. For the period involved in this Claim for Refund, Taxpayer filed its Federal income tax returns with the District Director of Internal Revenue, Phoenix, Arizona.

Taxpayer is a "life insurance company" as defined in Section 801(a) of the Internal Revenue Code of 1954 (the "Code"). Section 801(a) of the Code defines a life insurance company as follows:

> "For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c))."

Section 801(c) of the Code states that:

> ". . . the term 'total reserves' means—
>
> (1) life insurance reserves,
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

> (3) all other reserves required by law."

Therefore, from the foregoing statutory definitions, the qualification of an insurance company as a "life insurance company" depends upon a qualification fraction in which the numerator is the company's life insurance reserves plus its unearned premiums and unpaid losses on non-cancellable life, health or accident policies not included in life insurance reserves, and the denominator is the insurance company's total reserves as defined in Section 801(c) of the Code.

Transactions From 1957 to 1962

All of the outstanding stock of Taxpayer is owned by Southern Discount Company, a Georgia corporation. When Taxpayer commenced the insurance business in 1957, Taxpayer entered into a Reinsurance Agreement with American Bankers Life Assurance Company of Miami, Florida, (hereinafter referred to as "American Bankers") pursuant to which Taxpayer agreed to reinsure each and every life insurance policy and each and every health and accident insurance policy written by American Bankers in respect to debtors of Southern Discount Company and subsidiaries of Southern Discount Company, which companies were engaged primarily in the business of consumer finance. The Reinsurance Agreement provided that the liability of Taxpayer on the life insurance policies and the health and accident insurance policies shall follow the liability of American Bankers, except that the liability of Taxpayer arising under its reinsurance of health and accident policies would be on a month-to-month basis only. Such monthly liability of Taxpayer was further limited solely to the amount payable by American Bankers to Taxpayer under the terms of the contract, which amount, in effect, was the monthly earned portion of the total premiums. Thus, pursuant to the terms of the Reinsurance Agreement, Taxpayer's maximum amount of potential liability on the health and accident policies during any one month was limited solely to the amount of premiums earned on all such health and accident insurance covered by the Reinsur-

ance Agreement.* In consideration for this reinsurance, Taxpayer was paid a percentage of the monthly earned premium, initially 87½ percent, and increasing in later years to 90½ percent.

The Reinsurance Agreement between American Bankers and Taxpayer was amended by subsequent agreements between the parties, generally for the purpose of modifying the percentage of reinsurance premium paid by American Bankers to Taxpayer. The amendment of May 28, 1958, specifically provided that the liability of Taxpayer on health and accident insurance policies shall be on a month-to-month basis only, and such liability was to be limited to such amounts payable by American Bankers to Taxpayer under the terms of the Reinsurance Agreement.

The Reinsurance Agreement specifically provided that American Bankers was to maintain all unearned premiums, loss, and other reserves as may be required by law against the health and accident insurance policies. Therefore, American Bankers established and maintained the unearned premium reserve with respect to the health and accident insurance written by American Bankers and reinsured on a month-to-month basis by Taxpayer. Since the Reinsurance Agreement provided that American Bankers was to pay to Taxpayer only the earned portion of the health and accident premiums, American Bankers retained in its possession the unearned portion of the

* An insurance company writing health and accident insurance will usually have received the premium during the year which will not have been entirely earned at the end of the year. A reserve must be established at the end of the year to reflect the liability arising therefrom. The same principle applies for premiums which will not have been earned at the end of a month, and accordingly a reserve must be established at the end of each month to reflect the future liability arising from health and accident insurance written during the month. Unearned premium reserves are not based on recognized mortality or morbidity tables, but on the period for which the premium is paid. Therefore, the amount of the reserve established at the end of any period should be the pro rata portion of the premiums or unearned premiums at the end of the period. *See generally* R. Denney, A. Rua & R. Schoen, Federal Income Taxation of Insurance Companies § 5.5 and § 5.14 (2d ed. 1966).

premiums, and American Bankers established and maintained the unearned premium reserve required by State law to cover the liability for future claims arising under the health and accident insurance policies. At no time did Taxpayer receive the unearned premiums nor maintain the unearned premium reserve, and pursuant to the laws of the State of Arizona, Taxpayer was not required to maintain the unearned premium reserve with respect to such health and accident insurance so reinsured. Furthermore, in all of its reports filed annually with the Department of Insurance of the State of Arizona, Taxpayer never established or maintained an unearned premium reserve for such health and accident reinsurance. Also, the Department of Insurance of the State of Arizona, in its regular examination of Taxpayer's financial condition, never required or sought to require Taxpayer to maintain the unearned premium reserve with respect to the health and accident insurance so reinsured.

Transactions Commencing with 1962

In 1962, Taxpayer began writing directly life insurance policies and health and accident insurance policies with respect to the debtors of Southern Discount Company and its subsidiaries doing business in Georgia. With respect to this insurance, Taxpayer determined not to bear the insurance risk fully, but to reinsure a portion of the insurance risk with American Bankers. Accordingly, on April 18, 1962, Taxpayer entered into another Reinsurance Agreement with American Bankers with respect to the health and accident insurance written directly by Taxpayer on debtors of Southern Discount Company and its subsidiaries in the State of Georgia. Pursuant to this Reinsurance Agreement, American Bankers reinsured eighty percent of the health and accident insurance written by Taxpayer. The Reinsurance Agreement provided that the liability of American Bankers with respect to such health and accident insurance would arise immediately. For this reinsurance, Taxpayer paid American Bankers a percentage of the premiums paid on the policies.

In addition, American Bankers agreed to pay Taxpayer an experience refund based upon a formula set forth in the Reinsurance Agreement, pursuant to which, Taxpayer would be entitled to share in the profit from such health and accident insurance in the event the insurance reinsured by American Bankers was profitable. Such experience refund agreements were customary in the reinsurance industry, and were normal provisions in reinsurance agreements with American Bankers, and other companies engaged in the reinsurance business. There were other Reinsurance Agreements between Taxpayer and American Bankers with substantially identical provisions to cover subsidiaries of Southern Discount Company located in states other than Georgia.

The Reinsurance Agreements between Taxpayer and American Bankers were negotiated at arm's length, and there was no relationship between Taxpayer or Southern Discount Company and American Bankers during the period covered by this Claim for Refund, and thereafter, except as described herein, and except for a nominal amount of stock (approximately 2½%) of Southern Discount Company owned by American Bankers for the period March 15, 1962, through March 25, 1969.

On July 1, 1963, Taxpayer entered into an agreement with Life Insurance Company of North Carolina, pursuant to which Life Insurance Company of North Carolina reinsured with Taxpayer insurance written with respect to debtors of certain subsidiaries of Southern Discount Company engaged in the consumer finance business in North Carolina. Pursuant to this Reinsurance Agreement, one hundred percent. of the life insurance and one hundred percent. of the health and accident insurance was reinsured with Taxpayer, except, however, Life Insurance Company of North Carolina maintained a reserve of forty percent. of the cumulative total of premiums written with which to meet claims.

With respect to insurance written by Taxpayer, Taxpayer was required by law to maintain all reserves on such insurance, except that Taxpayer was not required under the laws of the State of Arizona to maintain the unearned premium reserve with respect to that portion

of the health and accident insurance reinsured with American Bankers. To the contrary, the Reinsurance Agreement provided that American Bankers was required to maintain all reserves on such portion of the health and accident insurance so reinsured. Taxpayer did not include such reserves in its reports filed with the Department of Insurance of the State of Arizona; and the Department of Insurance, in its examination of Taxpayer's financial condition, did not require Taxpayer to establish or maintain a reserve with respect to the health and accident insurance reinsured with American Bankers.

In determining the fraction described in Section 801 of the Code for years prior to 1962, Taxpayer was required to maintain reserves only with respect to the life insurance reinsured by Taxpayer, and no reserves were required to be established or maintained with respect to the health and accident insurance reinsured by Taxpayer, since Taxpayer only reinsured health and accident insurance on a month-to-month basis, and its liability was limited by the terms of the Reinsurance Agreement. Therefore, the amount of life insurance reserves constitutes the numerator, and, likewise, the amount of life insurance reserves constitutes the denominator, or the figure representing total reserves. Hence, Taxpayer clearly qualifies as a "life insurance company" pursuant to the definition contained in Section 801 of the Code for such period.

With respect to 1962, 1963 and 1964, when Taxpayer was writing life insurance and health and accident insurance directly, Taxpayer only reinsured a portion of the health and accident insurance with American Bankers, and Taxpayer did not reinsure any of its life insurance. Therefore, in this computation, the numerator would constitute all of the life insurance reserves, and the denominator, or the figure representing total reserves, would include the life insurance reserves plus the unearned premium reserve with respect to the portion of the health and accident insurance that was not reinsured by Taxpayer. Since this fraction results in life insurance reserves constituting more than fifty percent. of Taxpayer's total reserves, Taxpayer clearly qualifies as

a "life insurance company" as defined in Section 801 of the Code for such years.

The District Director of Internal Revenue erroneously determined that, for the taxable years of 1958, 1959, 1960, 1962, 1963 and 1964, Taxpayer did not qualify as a "life insurance company" within the meaning of Section 801 of the Code, and the District Director erroneously determined that Taxpayer was not entitled to taxation under Section 802 of the Code. Furthermore, the District Director erroneously determined that the Taxpayer did not compute or estimate its life insurance reserves on credit life contracts on the basis of a recognized mortality table and assumed rates of interest as required by Section 801(b) of the Code; and the District Director erroneously determined the Taxpayer did not reflect in its total reserves certain unearned premiums on health and accident contracts under certain Reinsurance Agreements. During the years 1957 through 1960, the District Director erroneously added to the total reserves of Taxpayer the total unearned premium reserves on all health and accident insurance written by American Bankers and reinsured by Taxpayer. During the years 1963 and 1964, the District Director erroneously determined that Taxpayer's total reserves should include that portion of the unearned premium reserve with respect to the percentage of health and accident insurance reinsured by the Taxpayer with American Bankers.

The Reinsurance Agreements between Taxpayer and American Bankers were valid, bona fide contractual agreements between the parties thereto, and such contracts had business and economic significance to both Taxpayer and American Bankers. Taxpayer entered into such reinsurance agreements for valid business purposes. One of the primary business purposes of the Reinsurance Agreements was to enable Taxpayer to indirectly insure the debtors of Southern Discount Company. During the years prior to 1962, Taxpayer was not qualified to engage in insurance business directly in those states in which Southern Discount Company conducted business, and therefore, in order to insure debtors of Southern Discount Company, Taxpayer had to enter into Reinsurance Agreements with an insurance company that was qualified to write insurance in those states in which Southern Discount Company conducted business. Also, taxpayer entered into such reinsurance agreements in order to qualify as a "life insurance company" as defined in the Internal Revenue Code. Such a purpose of reinsuring health and accident insurance, or failing to accept reinsurance on the health and accident insurance, except on a month-to-month basis in order to qualify for taxation as a "life insurance company", is a proper purpose, since Taxpayer is entitled to arrange its business affairs in such a manner as to minimize its tax liability, and to derive the maximum business advantages from the taxing laws. Taxpayer acknowledges that this was one of the business reasons for entering into the reinsurance agreements. Since the reinsurance agreements were valid and binding contracts between the parties, the reinsurance transactions in all respects had significant economic and business effects on both parties to the agreements, and accordingly, Taxpayer should not be required to establish or maintain any reserves with respect to the health and accident insurance that was reinsured as described herein.

In the alternative, if the District Director is correct in determining that Taxpayer should establish and maintain reserves with respect to the percentage of health and accident insurance reinsured by Taxpayer with American Bankers, such reserves should qualify and be treated as "life insurance reserves" as defined in Section 801 of the Code. Such health and accident insurance was written on the same policy forms and was combined with the life insurance which was also sold to the insureds. The policies of life insurance were noncancellable and the life insurance was coterminous with the health and accident insurance. Such health and accident insurance was for an average term of approximately 18 months and was noncancellable by the Taxpayer. Such noncancellable health and accident insurance should be included in the computation of unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health or accident policies not included in life insur-

ance reserves as described in Section 801(a)(a) of the Code; and the life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health and accident policies would comprise more than 50 per cent of Taxpayer's total reserves.

Further, in the alternative, if the District Director is correct in determining that Taxpayer should establish and maintain reserves with respect to the percentage of health and accident insurance reinsured by Taxpayer with American Bankers prior to 1962, the District Director erred in computing the amount of such reserves. In computing "total reserves," as defined in Section 801 (c), there should not be included therein any premiums paid in advance. The reinsurance agreement between Taxpayer and American Bankers provided for monthly premium payments from American Bankers to Taxpayer and the unearned premium reserves claimed to exist by the District Director can exist only where there are single premium payments. However, single premiums paid under a monthly premium contract would clearly pay premiums in advance of the due date, thereby creating advance premiums and not unearned premiums as claimed by the District Director; therefore, even if there were single premium payments from American Bankers to Taxpayer, rather than monthly premium payments, the total reserves computed pursuant to Section 801(c) would not include the amount relating to advance premiums. Therefore, for such period Taxpayer would qualify as a "life insurance company" since the computation of "total reserves" should exclude the advance premiums, and the life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies would comprise more than 50 percent of Taxpayer's total reserves.

With respect to years, subseqeunt to 1961, Taxpayer, in accordance with its Reinsurance Agreement with American Bankers, remitted to American Bankers a percentage of the single premium for each policy reinsured with American Bankers at the end of the quarter with respect to which such premiums were collected. Had Taxpayer withheld any portion of such single premiums due

to American Bankers, which would have at least been necessary to have created unearned premiums on the percentage of insurance reinsured as is claimed by the District Director, Taxpayer would have been in violation of its agreement to pay American Bankers single premiums. If such amounts had been withheld they would not in fact have constituted unearned premiums but would have been a liability of Taxpayer to American Bankers since American Bankers by contract was the insurer of the risks represented by the percentage of reinsurance and American Bankers was obligated to pay claims arising from such risks and consequently required by law to maintain the unearned premiums for such risks. Thus, for the taxable years subsequent to 1961 Taxpayer's life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies would comprise more than 50 percent of Taxpayer's total reserves.

Further, in the alternative, if the District Director is correct in determining that Taxpayer should establish and maintain reserves with respect to the percentage of health and accident insurance reinsured by Taxpayer with American Bankers for years subsequent to 1961, Taxpayer would, nevertheless, qualify as a "life insurance company" as defined in Section 801(a) of the Code. In computing the amount of "total reserves" the amount attributable to such health and accident insurance reserves would be the cost of carrying the insurance risk (see Reg. § 801-3(e)), and when such amount representing the cost of carrying the insurance risk is included in the computation of "total reserves," Taxpayer would qualify as a "life insurance company" for years after 1961, since its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health and accident policies comprise more than 50 percent of Taxpayer's total reserves.

Further, in the alternative, if the District Director is correct in determining that Taxpayer should establish and maintain reserves with respect to the percentage of health and accident insurance reinsured by Taxpayer with American Bankers, the District Director, neverthe-

less, erroneously calculated the numerator of the fraction expressed in Section 801(a) of the Code by failing to include in the calculation of the numerator the unpaid losses on noncancellable life insurance contracts. Taxpayer recognizes that it is proper to include such unpaid losses in the calculation of the denominator, total reserves, as the District Director has recognized in his computations, but such amount must also be included in the calculation of the numerator. (IRC 1954, § 801(a)(2).) In computing both the numerator and denominator the statute clearly provides that there must be included the amount representing unpaid losses on noncancellable life insurance contracts.

The life insurance reserves established by Taxpayer during the period in question were computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. Such life insurance reserves constituted amounts set aside to mature or liquidate future unaccrued claims arising from life insurance contracts, and such reserves were required by law.

For the reasons hereinabove stated, the District Director erroneously determined a deficiency in Taxpayer's income tax as a result of such determination and as a result of the erroneous re-computation and adjustments made to the Taxpayer's reserves.

(Number and Title Omitted.)

(Filed: April 23, 1971)

ANSWER

The defendant, the United States of America, by its attorneys, in answer to the petition filed herein, denies each and every allegation of the petition, except to the extent specifically admitted below:

COUNT I

1. Defendant admits the allegations contained in paragraph 1.

2. Defendant denies any income taxes and interest were erroneously overpaid and collected; defendant admits the remaining allegations contained in paragraph 2.

3. Defendant denies there has been any overpayment of federal income taxes and interest; defendant admits the remaining allegations contained in paragraph 3.

4. Defendant admits the allegations contained in paragraph 4 except to state that the notice of deficiencies was sent to the plaintiff by the Acting Regional Commissioner, Internal Revenue Service, Southeast Region, and that the deficiencies in federal income taxes were in the aggregate of $233,762.75, not $235,762.75 as alleged.

5. Defendant admits the plaintiff paid $351,393.88 but states that the Internal Revenue Service's Certificate of Assessments and Payments (Form 4340) for the taxable years ended December 31, 1958, 1959, 1960, 1962, 1963 and 1964 shows the payment date thereof to be August 1, 1969.

6. Defendant admits the allegations contained in paragraph 6.

7. Defendant admits the allegations contained in paragraph 7 except to state that the Internal Revenue Service receipt date stamped on each of the plaintiff's original Claims for Refund shows they were filed on October 21, 1969, not October 14, 1969 as alleged.

8. Defendant admits the allegations contained in paragraph 8.

9-12. Defendant denies the allegations contained in paragraphs 9 through 12.

13. Defendant is presently unable to obtain knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 13 except admits that "During the taxable years ended December 31, 1958, 1959 and 1960, Plaintiff was a party to a Reinsurance Agreement with American Bankers Life Assurance Company * * *."

14. Defendant denies the allegations contained in paragraph 14.

15. Defendant is presently unable to obtain knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 15.

16-20. Defendant denies the allegations contained in paragraphs 16 through 20.

COUNT II

1-10. Defendant realleges its answers to paragraphs 1 through 10 as stated above.

11-12. Defendant realleges its answers to paragraphs 13 and 15 as stated above.

13-17. Defendant denies the allegations contained in paragraphs 13 through 17.

COUNT III

1-10. Defendant realleges its answers to paragraphs 1 through 10 as stated above.

11-12. Defendant realleges its answers to paragraphs 13 and 15 above.

13-20. Defendant denies the allegations contained in paragraphs 13 through 20.

WHEREFORE, defendant prays that the petition be dismissed with costs against the plaintiff.

Respectfully submitted,

/s/ Johnnie M. Walters
JOHNNIE M. WALTERS
Assistant Attorney General

/s/ Mark Segal
MARK SEGAL
Attorney

April 16, 1971

[1]

(Number and Title Omitted)

(Filed:)

TRANSCRIPT OF PROCEEDINGS

LOCATION OF HEARING:

UNITED STATES COURT OF CLAIMS
ATLANTA, GEORGIA

DATE:

July 17, 1973

BEFORE:

THE HONORABLE GEORGE WILLY

APPEARANCES:

ROGER A. SCHWARZ
HERBERT GROSSMAN
for the Defendant
E. MICHAEL MASINTER
JAMES H. LANDON
for the Plaintiff

* * * *

[23] TESTIMONY FOR PLAINTIFF

Pursuant to the order of reference by the Honorable, the United States Court of Claims, in the above entited cause, testimony on behalf of the Plaintiff was taken as follows:

THE COURT: Do you solemnly swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you God?

THE WITNESS: I do.

THE COURT: Be seated.

THE REPORTER: Would you state your name and [24] address for the record, please?

THE WITNESS: John William Born, 1110 Kingston Drive, Northeast Atlanta, Georgia.

THE REPORTER: And, how do you spell your last name?

THE WITNESS: B-o-r-n.

JOHN WILLIAM BORN,

a witness produced on behalf of the Plaintiff, having first been duly sworn by said Commissioner, was examined and in answer to interrogatories, testified as follows:

DIRECT EXAMINATION

BY MR. LANDON:

Q Mr. Born, would you tell us by whom you are presently employed?

A Southern Discount Company.

Q Is Southern your only employer?

A That's right.

Q Do you hold positions with any other companies?

A Yes, with various subsidiary companies owned by Southern Discount.

Q How long have you been employed by Southern Discount group?

A Since March the 2nd, of 1959.

Q What is your position with the Plaintiff?

A I'm financial vice president, and secretary and [25] treasurer.

Q And, how long have you held that position with Consumer Life Insurance Company?

A Since, about 1965.

Q Can you tell me, and tell the Court, what is the nature of your responsibilities as the secretary-treasurer and financial vice president?

A I supervise the overall administrative functions of the company, namely record keeping, and filing reports of all sort—of all types.

Q Among those reports are you familiar with the tax returns of the company?

A Yes, I am.

Q And, with the annual statements required to be submitted by the company?

A Yes.

Q Do you hold professional degrees or certificates, Mr. Born?

A Yes, I do.

Q And, what are those?

A I'm a CPA, and also a member of the Bar.

Q Thank you. Can you tell us please the relationship of credit insurance in general to the business of Southern Discount Company, the parent of Consumer Life Insurance Company?

[26] A Southern Discount is licensed under the State Small Loan Laws to make small loans, and these statutes authorize the companies to sell credit life and accident health, and also fire insurance, as an agent for insurance companies.

Q Prior to the formation of Consumer Life, how did Southern Discount arrange for credit insurance for its customers?

A They were represented by American Bankers as agent, and prior to that some other companies.

Q But, Southern Discount Company was the agent?

A That's right. Or some other subsidiary companies.

THE COURT: This authorization to sell insurance, —that is limited to insurance incident to the company's outstanding credit risks, or—

THE WITNESS: That's right, yes.

BY MR. LANDON: (Resuming)

Q Did Southern Discount receive commissions for acting as agent on those sales of insurance?

A Yes, it did.

Q How were those commissions determined?

A They were generally regulated by the states, North Carolina limits the commission to 40 percent, Georgia to advance commission of 50 percent, and then depending

upon [27] the profitability of the business, an additional commission could be earned of up to 15 percent.

Q What motivated Southern Discount to consider forming Consumer Life Insurance Company at this time?

A To increase its earnings, and—out of the insurance, which is sold.

Q How could those earnings be increased by forming an insurance company subsidiary?

A Well, by making within the company the profit that was earned by the insurance company, over and above the commissions paid to the agent.

Q Can you explain what that profit might be, in other words we might take a hypothetical transaction, of not—not considering any of our re-insurance questions, just for an insurer, how does an insuring company make money—assume that it is paid $100.00 in premium, what happens to that?

A If you assume $100.00 in premium, the agent's commission would be $50.00 or 50 percent, the loss ratio depending upon whether it is life, or accident-health, could vary from as low as 10 to 15 percent, or as high as 30 or 40 percent. So, that if you were to take the commission expense of $50.00, and add for example a $20.00 loss ratio, for claims, that would leave $30.00 to —to the insurance company to cover its overhead, premium, taxes and profitabil- [28] ity.

Q And, would anything else come out of that $30.00? You mentioned a contingent commission, would that—

A Assuming—based on a loss ration of 20 percent, the company would pay an additional contingent commission of up to 15 percent.

Q Right, then, whatever was left after that would be the profitability to an insurance company?

A That's correct.

THE COURT: Before you were getting the commission income as a practical matter, weren't you? You didn't have anybody selling this insurance, the—the lender sold it didn't he, when he loaned the money?

THE WITNESS: That's correct, prior to the formation of the company, the finance company officers were

agents for American Bankers, and received a commission —insurance.

THE COURT: Well, they had been getting this all along, and they didn't improve their earnings?

THE WITNESS: Not as it relates—

THE COURT: Not in that respect—

THE WITNESS: No, not as it relates to the commission, they would not improve it by formation of a company.

[29] THE COURT: Right.

BY MR. LANDON: (Resuming)

Q The improved earnings though came from what?

A The profitability of the life insurance company operation, as such.

Q Thank you. Can you tell us as opposed to the insurance company, how a re-insurance company makes money?

A The re-insurer normally re-insures through a contract or a relationship with another insurance company, who is authorized to write business in a particular state, where the re-insurer may not be, and with the general plan being that the re-insurer receives certain premiums in order to insure the risk, and bears the losses, related to those premiums.

For example, you might have a—a treaty that would call for such as in the case of the treaty between Consumer and American Bankers, Consumer Life would receive 87½% of the premiums. American Bankers would retain 12½%, pay the premium taxes and their overhead. With Consumer paying the losses, and commissions if any out of the 87½%, and retaining what additional profit might be available.

Q So, then, would it be correct to say that it is the same sort of profitability that an insurance company [30] has, it is just that if you are not qualified as an insurance company, the way that you do it is to be a re-insurance company?

A You cannot normally get through a re-insurance contract 100 percent of the premiums, you can get 87 to 90, sometimes higher, percent of the premiums.

THE COURT: When you say you, you are speaking of the re-insurer?

THE WITNESS: That's correct, sir.

BY MR. LANDON: (Resuming)

Q What exactly is re-insurance?

A Re-insurance is a contract that is entered into between insurance companies, the result of which is to spread the risk over a—a period of years. It is normally done to—as a capital consideration, and in the case of Consumer, the re-insurance contract was—was a consideration to permit them to increase its earnings through this arrangement.

Q Why did Southern Discount create a subsidiary which acted as a re-insurer, rather than as a direct insurer?

A Because of capital requirements, the re-insurer, Consumer, could be formed for approximately $38,000.00 capital, and get into the business via the re-insurance arrangement, to form a company to write directly. It [31] would have required approximately $400.00 capital —$400,000.00 capital to do so in Georgia, at the time.

Q But the re-insurer was not required to meet that capital requirement?

A That's correct.

THE COURT: From the standpoint of the insurance —what you might call insurance function, what if anything is different in the nature of a re-insurer, on the one hand, and an insurer on the other hand?

THE WITNESS: The primary difference would be that the re-insurer does not issue the policies under its name.

THE COURT: But that's mechanical, isn't it?

THE WITNESS: That's mechanical.

THE COURT: I'm saying, from—in the context of insurance function, that is to say, I suppose what—ah—assumption of risk, is there any institutional or intrinsic difference between an insurer on the one hand, and a re-insurer on the other hand?

THE WITNESS: The only difference would be that the re-insurer joins another company, in the carrying out of the functions of an insurance business. And,—it was just a means whereby the companies share in the profits, and also the risk.

THE COURT: But, would it be fair to say that [32] —that assumption of risk is the basic hallmark of the two—

THE WITNESS: Yes, sir.

THE COURT: Enterprises, that they have in common?

THE WITNESS: Yes, sir, that's right.

BY MR. LANDON: (Resuming)

Q Mr. Born, I want to show you now certain of the Plaintiff's Exhibits that we have identified previously, and would like for you to comment on each one of them, just describe what it is. Plaintiff's Exhibit #2?

A This is the re-insurance treaty between American Bankers and Consumer Life Insurance Company, dated in 1957, which was the first re-insurance agreement.

Q I show you Plaintiff's Exhibit #3?

A This is the re-insurance treaty between Consumer Life Insurance and American Bankers Insurance Company, dated in 1962, which covered business ceded to American Bankers by Consumers.

Q Plaintiff's Exhibit #4?

A This is a re-insurance treaty between the Life Insurance Company of North Carolina, and Consumer Life Insurance Company. This treaty arose out of the fact that Southern Discount Company purchased, I believe it was three or four branch offices in North Carolina, and through [33] this arrangement Southern through Consumer was able to get an additional income over and above the limited commission that was payable by North Carolina, or that North Carolina allowed, into the business that was in force, and sold by the Insurance Company of North Carolina at the time, this amounted to approximately 7½ percent additional income.

Q Plaintiff's Exhibit number 5—

MR. SCHWARZ: Off the record for a moment, please I didn't hear the last—

(Whereupon, the Reporter played back part of the tape.)

BY MR. LANDON: (Resuming)

Q Plaintiff's Exhibit #5?

A This is the insurance treaty between Consumer Life Insurance Company, and American Bankers, and it covered business ceded to American Bankers, under insurance written in North Carolina.

Q Plaintiff's Exhibit #6?

A This is a re-insurance treaty between Consumer Life Insurance Company and American Bankers, under which Consumer ceded to American Bankers the business written in the State of Florida.

Q Thank you. I show you Plaintiff's Exhibit 16, can you describe what these Exhibits constitute?

[34] A These were the re-insurance ceded statements that Consumer received from American Bankers, under the 1957—1957 re-insurance treaty.

Q Can you state what is shown on the face of this?

A Yes, the—under the treaty, American Bankers was to remit to Consumer on the life—credit life business, the premiums written, and there is a calculation showing the session of the credit life business, showing that Consumer received 90½ percent, which is for the year January, 1959, and under this particular Code, received 90½ percent of the written premium, and Consumer reimbursed American Bankers with the losses paid to that period, and shows the reserve set aside for incurred, but unreported claims, which—with the balance being paid to Consumer. This was a net remittance, but it included the premiums, the losses, on a net basis.

Q I show you Plaintiff's Exhibit 17, and ask you to comment solely on this Exhibit?

A This is a re-insurance assumed statement, showing that American Bankers, assumes risk under the 1962 agreement. This showed that—a summarization of the

premiums assumed by them, the computations of unearned and earned premiums, and the amount re-insured by Consumer as shown as 80 percent, with a resulting computation showing on a quarterly basis the experienced refund, due Consumer for [35] that particular period.

Q To turn your attention now to the re-insurance treaty that we first examined there, the re-insurance treaty dated 1957, how were the credit life insurance—not the credit accident and health premiums, physically handled under that—under that re-insurance treaty?

A They were ceded by American Bankers to Consumer on an as written basis, less their retention.

Q As re-insurer then, to what extent was Consumer Life liable under that re-insurance method for the life claims?

A Liable for all of the life claims.

Q Did the method of re-insuring credit accident and health insurance differ from the method of re-insuring credit life, insofar as the transfer of the premium payments went?

A Yes. On the credit accident and health insurance, the premiums were ceded to Consumer on an as-earned basis.

Q What does as earned mean?

A The accounting treatment for an accident and health premium or insurance premiums generally, the policy is written,—the policy might be written for 15 or 18 months. So, that you account for the premium as being earned, and unearned, based on the expiration of time. This generally can be done—was done on a level life, under [36] pro rata method, under reducing—and under accident and health, generally under a rule of 78's or sum of the digits' method.

Q Were—why was there a difference in the way that these two, the life and the accident and health were re-insured, one as written, one as earned?

A The—had Consumer re-insured the accident and health on an as written basis, it would have had an economic loss in going into the business, based on the capitalization of the company, which was originally some

$38,000.00. The re-insurance of the accident and health on an as earned basis was considered necessary to protect the capital of the company, and to enable it to continue to qualify to re-insure the life business.

Q Did this method of re-insurance affect the capital appearance of the company in any way or the capital picture of the company?

A Yes, because the financial statement of Consumer would not reflect reserves for accident and health policies, it would only reflect claims for one month.

Q Did it affect the consolidated net income picture or net capital picture for Southern Discount in general?

A Ah—of course the—Southern's overall income was increased by reason of having formed the life insurance company, but it would not have been increased as much, had [37] Consumer taken the business—the re-insurance business on the accident and health on an as written basis, because Consumer Life would have had to put up 100 percent of the unearned premium in reserves, when it was only receiving like 90 percent of the premium. This would have caused a decrease in earnings.

Q Was Southern Discount at this time involved in any sort of borrowing of money—is—was it continually borrowing, or was there some capital need at this time?

A Southern has regularly borrowed, I don't know if there hasn't been a case when Southern did not need additional money, so that certain ratios that finance companies borrow on, and it was one of my responsibilities to see that these ratios were maintained in a favorable relationship to obtaining bank funds, and long term funds from lenders.

Q Did the re-insurance agreement, which we have discussed, and the re-insurance of credit accident and health on an as earned basis, affect that capital—that consolidated capital picture of Southern Discount in either way, adversely or—or in its favor?

A Well, had Consumer re-insured the A&H on an as written, the income would have been decreased, yes.

Q You mentioned the term economic loss, and stated I believe that you would have had to have retained reserves [38] in the total amount of the premiums written,

had you re-insured as written, what exactly would have caused the economic loss that you referred to?

A The requirement that Consumer set up 100 percent of the unearned premium.

Q Where does the loss come in with that? In other words how much does Consumer receive—how much does it reserve?

A Well, under the treaty—originally it only received 87½ percent of the premium, and it would have been required to set up the full 100 percent of unearned in the reserve.

Q And, under the treaty, where—where was the 12½ percent retained?

A That was retained by American Bankers.

Q As to the credit life insurance, which was re-insured under the 1957 treaty, what reserves were maintained by Consumer Life and what reserves were contained by American Bankers?

A Consumer on the credit life, since it re-insured the business on a written basis, maintained the total required reserve, which was a reserve estimated, based on mortality tables at approximately 40 percent of the unearned premiums.

Q Those reserves therefore, are different from [39] the sorts of reserves required to be retained for accident and health insurance?

A That's correct.

Q Ah—who under this same treaty—the 1957 treaty, as it was amended, maintained the accident and health insurance reserves?

A American Bankers, I assume it was their contractual obligation to do so under the treaty—Consumer—

MR. SCHWARZ: I object to that answer, the contract not only speaks for itself, but doesn't have those terms in it, I don't think.

BY MR. LANDON: (Resuming)

Q All right. Did Consumer Life Insurance maintain any reserves as to the accident and health insurance, re-insured under the 1957 treaty?

A No, it did not—no it did not.

Q Are you aware of whether American Bankers maintained any reserves as to those premiums?

A Yes, I have been told that they did, yes.

Q Were you ever required by any—by any regulatory agency, or anyone else to maintain reserves as to that insurance which you re-insured?

A No.

Q The accident—no?

A No.

[40] Q How were these various reserve liabilities reflected on Consumer Life's annual statements in its tax returns for the credit life and for the accident and health?

A The same as—as they were reflected in the annual statements,—the reserves—for the life insurance was reflected as a liability. The reserves under the periods 1957, 1958 through 1961, the company did not have an accident and health reserve.

Q Is Consumer regulated by law?

A Yes, it is.

Q What regulation does exist for Consumer in the various states in which it operates?

A The home state, being Arizona, regulates Consumer as to certain financial statement figures, investments, as to what generally the—sets up the rules and regulations for the conduct of an insurance company operation. When you get admitted into a state to write direct business, then you are subject to regulations by that state as to policy forms, but primarily the home state law, as I understand it governs the financial statement practices, and establishment of reserves, and—

Q So, as to the reserve requirements of Consumer Life, which state law were you concerned with?

A Generally, the reserves were determined by the [41] actuary, but based on my understanding, the—the law of the State of Arizona was the—the law that we were concerned with maintaining the reserves under.

Q Did Consumer Life comply with those reserve requirements of the State of Arizona?

A Yes.

Q Was Consumer Life ever examined by the Insurance Department of the State of Arizona?

A Yes.

Q How often did that occur under—in the years in which we are concerned, 1957 through 1964?

A It was examined—the period ending December 31, 1959, and then the period ended December 31, 1963. Normally these examinations are conducted every three years, but we went from 1959 to 1963 for some reason without one.

Q That was in—who determined when they were examined?

A Well, as I recall, I requested the—the December, 1963 examination, because we contemplated making application to do business in other states, and this is generally a requirement for that.

Q Was—in either of those examinations, was Consumer's method of maintaining the reserves, which you have just described to us, ever challenged or disapproved?

A Not to my knowledge.

[42] Q Would you have knowledge of such a challenge or disapproval?

A Yes.

Q What is the nature of that examination by the Insurance Department of the State of Arizona? What do they in fact physically do?

A They conduct a general audit of the assets and liabilities of the company.

Q During period I you stated I believe, that your annual statement reflected reserves for the credit life insurance, is that correct?

A Yes.

Q Then, you stated—or what did you state concerning your annual statements as far as reflecting any reserves for credit accident and health insurance?

A Under the first treaty, where Consumer was a re-insurer, on the accident and health on an earned basis, there was no reserves maintained.

Q Why did Consumer and American Bankers enter a different re-insurance treaty in 1962?

A Ah—Consumer had—had been admitted to—as a direct writer, and the—really it is a part of my analysis of the—of the operation. We went to another company and got proposals to find out just what—what the net cost of the profitability of the business [43] could be to Consumer, so that the re-insurance treaty, in 1957 would not be applicable to the company as a direct writer. We didn't feel that we could carry the full risk, so that that gave rise to a re-insurance treaty, and—because of the fact that as you build the accident and health business, you—you have to set up the full unearned premium, and pay the commission on it, it creates a loss, so that based on my analysis of the business, we determined to continue the re-insurance treaty in force to execute a re-insurance treaty to cover the direct business being written. This was in early 1962.

THE COURT: Excuse me, before you move into this current era, referring now to the prior period, in which, as I understand it, Consumer was functioning as a—a re-insurer with American Bankers, operating as ceding carrier, for both credit life and A&H, correct?

THE WITNESS: Yes, sir.

THE COURT: All right. Now, recognizing that in the two categories the—the—the nature of the risk hazards are different, nonetheless, if you examine the risk assumed by the ceding carrier on the one hand, in your credit life, and on the other the A&H, and then look at the extent to which Consumer as the re-insurer in each instance relieved American Bankers of the risk to which it had exposed itself with the policy holder, do you follow [44] what I am saying so far?

THE WITNESS: Yes, as to the credit life, yes.

THE COURT: All right. Did—or was there any difference in the degree of risk to the insured that Consumer assumed as a re-insurer in the case of A&H as there was in the case of credit life, or put otherwise, did Consumer assume any lesser portion of the risk as a whole in the case of A&H than it did credit life?

THE WITNESS: No, the contract stipulated that the re-insurer would assume 100 percent of the risk.

THE COURT: In each instance?

THE WITNESS: In each instance. But, that the contract was amended in 1958, to limit Consumer's liability to the earned premiums on a month to month basis, which meant that Consumer as an operating company would not be liable to re-imburse American Bankers, the ceding company, except to the extent of earned premiums on the accident and health.

THE COURT: From 1958 forward?

THE WITNESS: That's right.

THE COURT: Proceed.

BY MR. LANDON: (Resuming)

Q You have stated that Consumer Life and American Bankers based on your investigation of the business and the decision to qualify as a direct writer, then entered into [45] a second re-insurance treaty in 1962. What was the effect of that treaty as to the credit life written by Consumer Life?

A Consumer retained all of the—the credit life insurance, the risk, the whole operation, the American Bankers did not re-insure any of the credit life business.

Q And, what was the effect of that treaty on re-insurance of credit accident and health insurance?

A We—Consumer ceded to American Bankers 80 percent of the risk on accident and health.

Q did this re-insurance on an 80 percent basis, have an effect—were the terms of the treaty intended to have an effect on Consumer's capital structure?

A Yes, because without the re-insurance, we would have had to build the reserve plus pay the commission to the finance companies, resulting in a—a—an operational decrease in earnings, and thereby decreasing capital.

Q As to the 80 percent of the credit accident and health insurance, which was ceded by Consumer Life to American Bankers, did Consumer Life maintain any unearned premium reserve?

A Ah—not as to the 80 percent. Consumer did maintain and carry the reserve on 20 percent, which was retained.

Q Who maintained the reserves on the 80 percent?

[46] A American Bankers.

Q On whose annual statements were those reserves reflected?

A On American Bankers.

Q Did any state regulatory body ever require Consumer to maintain those reserves or indicate that those reserves were being incorrectly maintained by American Bankers, rather than by Consumer?

A No.

(Pause.)

MR. LANDON: That concludes our examination.

THE COURT: We'll have a ten minute recess.

(Whereupon, the hearing in the above case was recessed at 10:29 as described above.)

THE COURT: Very well, before cross I would like to inquire of the parties whether they discriminate or distinguish at all between the—the situation presented by the Plaintiff's re-insurance of A&H up to this point in time in 1958, at which I understood the witness to state that its liability as a re-insurer by treaty amendment became limited to its premium receipts as contrasted with the situation obtaining there before, which I understood it, it was on the entire risk.

MR. MASINTER: If Your Honor, please, we do not distinguish, because we have treated that all along [47] as merely a clarifying amendment, more like clearing up a typographical error.

THE COURT: Do you mean that you are contending that as a matter of law, as it were, that—that Consumer's liability as a re-insurer was at all times limited to its premium receipt, so that the—

MR. MASINTER: Well, that's—that's—

THE COURT: 1958 action then, in your view was simply declaratory of the existing arrangement?

MR. MASINTER: For the original re-insurance contract of re-insured accident and health, on an as earned basis. Now, the clarifying amendment merely sets forth in the words what it meant by an as earned basis.

THE COURT: But didn't the witness indicate that there was a reduction in risk exposure to the Plaintiff as a re-insurer by virtue of this 1958 amendment. I thought that he told me that prior thereto in both the credit life and the A&H, Consumer as the re-insurer assumed the entire risk. That is to say the entire risk that the ceding—that American Bankers assumed vis a vis its insured.

Then I thought he went on to say, that in the case of A&H, by virtue of a treaty amendment, in 1958, its risk assumption was narrowed in that it was subject to a ceiling amount. That ceiling being its premium receipts, or maybe I misunderstood him.

[48] MR. MASINTER: Well, I think that is what he said, but—ah—what he did not go further to say, is that really the parties treated it from the very outset in the same manner as they did after the 1958 amendment, and actually I think the amendment was the early part of 1959.

There was no difference in the treatment, no difference in the forwarding of premiums, no—no intent difference—the intent was there all along from the very outset, and I don't think that there was any difference. I think that he was just trying to pinpoint the date.

But you might—

THE COURT: Excuse me, you say the intent, by that you mean the intent that Consumer's not assume the risk without limitation? That it was never intended that it assume the entire risk incurred or shouldered by American Bankers as the ceding carrier.

MR. MASINTER: I think that that is correct, Your Honor. I think that the contract is clear that the intent was that the re-insurer, Consumer, only re-insured the A&H business on an as earned basis from the very outset. And, as earned means, as I understand the insurance actuarial and accounting principles, on a month to month basis. And, all that the 1958 or 1959 amendment did was to say, that the liability of Consumer will be on an as earned or month to [49] month basis, and that's really all it was from the very beginning.

So, I don't—I don't take the amendment to have any substantive or risk shifting difference. I think that that was the way it was intended to be from the very outset, but this really just clarifies it.

THE COURT: Well, in any event, can I correctly assume that the amendment in question is in the record as a part of Plaintiff's 2?

MR. MASINTER: Yes, sir, it is, and—and if I might—

THE COURT: Well, that's fine. You all may cover it any way you see fit, I just thought at the outset that I would like to know whether there was a contention that there was any difference, and you have answered that in your view there is no difference.

MR. MASINTER: There has—there has never been any contention by us or by the Government that it should be treated any differently, and really it has just been assumed that this was just a clarifying type of amendment, which set forth the intent of the parties from the very outset, of—

THE COURT: All right.

MR. MASINTER: Of the agreement, and had no substantive effect. And, his answer I think would stand [50] really from the very beginning of the contractual arrangement between Consumer and American Bankers.

THE COURT: All right, proceed, Mr. Schwarz.

MR. SCHWARZ: Your Honor, we do intend to pursue the—these terms in the agreement on cross examination. I think that that may clarify your question somewhat more.

CROSS EXAMINATION

BY MR. SCHWARZ:

Q Mr. Born, would you agree that under both of the insurance treaties that were the subject of your direct examination, all losses that were ultimately paid to an insured, were paid out of funds which would otherwise have been earned by Consumer under the treaties, and not by American Bankers?

A Well, they were all paid out of the premiums.

Q And, if those premiums—if the losses were not paid because they were not incured, that is because the loss did not arise, would the money that would otherwise have been used to pay those losses be earned by Consumers under both treaties?

A Ah—yes, because, I suppose the premiums—the source for the payment of the losses—as risk.

Q Could you—I think that I understand your answer, but I believe you summarized it a little too quickly, [51] could you be a little clearer?

A The premiums—generally, the revenue is a source to pay the losses with. Now, under the first contract, the premiums were generated through American Bankers, so that the losses were transferred to Consumer through the—through the first re-insurance treaty. Under the second contract the policies were written by Consumer, with a portion of the loss being transferred to American Bankers by the treaty.

Q Now, there was experience refund provision under the second treaty, is that right?

A That's correct.

Q Was the fact of that experience refund provision such that any portion of that total amount subject to the refund, which was not used to pay losses, would be returned to Consumer?

A Ah—yes—

Q As an experience refund?

A As an experience refund.

Q Is it correct, that under the second treaty then, American Bankers stood to earn a three percent flat fee under the agreement, and regardless of the loss experience, it could not earn more or less than three percent?

A Well, American Bankers stood to earn the three [52] —the three percent, plus the investment income on the reserve funds, which they held.

Q You are referring to the income on a portion of the premium which was temporarily transferred to American Bankers?

A That's correct, right.

Q And, that was the same portion that was subject to the experience refund back to Consumer in the event of a favorable policy experience?

A In the event of a favorable loss ratio, yes.

Q Is it your understanding that as a technical matter under the insurance law, the direct writer is the only company as between it and a re-insurer, which has a liability to the insured, and that a re-insurer is technically liable only to the direct writer?

A That's correct generally.

Q But is it the effect of both of these treaties that Consumer whether it was the re-insurer under the first treaty or the ceding company, that is the direct writer under the second treaty, was the one that retained the ultimate liability for any claims that were paid to the policy holder?

THE COURT: What does ultimate mean?

MR. SCHWARZ: I'm using ultimate to distinguish between the liability that the direct writer has to pay [53] the claim to the insured, and the liability of some other company, which may be incurred under a treaty to pay the direct writer for the claim which it has paid the insured under the policy.

THE WITNESS: I'm not sure that—that I understand your question fully.

BY MR. SCHWARZ: (Resuming)

Q Let me make it a little simpler. Under the first treaty, American Bankers was the direct writer, and Consumer was the re-insurer?

A Yes.

Q When American Bankers entered into a policy with an insured, it became obliged to pay claims that were incurred by the insured?

A Yes.

Q Under the re-insurance agreement, the direct writer knew that any claims which it paid to the insured would be repayed to it by Consumer as part of the re-insurance agreement, isn't that correct?

A Yes, I think that it provided that the—the risk of the re-insurer would follow the risk of the ceding company under the policy.

Q And, it was—

THE COURT: Well, excuse me, Mr. Born, is it your understanding that that obtained from 1957 on until [54] era II, as you have called it here, where they reversed their roles?

THE WITNESS: Yes, sir.

THE COURT: So, that was unaffected by this 1958 amendment that you mentioned earlier?

THE WITNESS: As to the—the language—

THE COURT: A&H.

THE WITNESS: —in the contract called for one hundred percent of the risk to be insured—reinsured by Consumer, and that the liability of the reinsured would follow the liability of the ceding company to the insurer.

THE COURT: And, that never changed by virtue of this 1958 treaty amendment that you mentioned earlier?

THE WITNESS: No, only as to the point in time, as to which when there would be a settlement of this liability between the companies.

THE COURT: But, in terms of risk assumption and exposure apart from the settlement or when or where or how, there was never a change in that?

THE WITNESS: That's right, it was one hundred percent by reason of the contract, yes.

THE COURT: I see. Proceed.

BY MR. SCHWARZ: (Resuming)

Q Based on the answer that you have just given, Mr. Born, isn't it correct that the term as earned which [55] you used in description of the accident and health reinsurance treaties refers to the method by which payments were made between the ceding company, American Bankers, and the re-insurer, rather than in terms of any modification of the ultimate liability of the re-insurer, Consumer, for the payments which American Bankers paid?

A I would look at it on the basis that—under the re-insurance contract as an obligation for Consumer to

re-imburse American Bankers for losses, but the first contract called for that liability to be limited to the earned premiums on a month to month basis.

Q Did that term that you are referring to in any way practically limit the liability—the ultimate liability of Consumer for all claims regardless of how high they were?

A Well,—

Q I believe that you stated, did you not, to—in answer to Commissioner Willy's question that one hundred percent of the liability of American Bankers under the treaty was re-insured with Consumer, is that correct?

A That's right.

Q Right, and the payment provision—

MR. MASINTER: Your Honor, I would suggest that you allow him to answer one question at a time. I think that he has gotten about three questions involved there.

[56] MR. SCHWARZ: Well, he just gave an answer to a question, and there is one other question pending.

THE COURT: Proceed.

BY MR. SCHWARZ: (Resuming)

Q Now, let's clarify what is meant by the term as earned under the reinsurance treaty—the first reinsurance treaty. Each month American Bankers would receive all the premiums written by Southern Discount during the previous month, isn't that correct?

A That's correct.

Q On the accident and health policies?

A Yes.

Q Okay. Now, each month, losses would be incurred under the outstanding policies, is that correct?

A Yes.

Q Under the terms of the treaty, is it your understanding that in order to determine how much money would be transferred from American Bankers to the reinsurer, you would compute first the figure called premiums earned, is that correct?

A Ah—

Q This is part of the computation, I'm not trying to take the whole thing—

A Yes, that was a part of it.

Q All right. Now, premiums earned would you say [57] was effectively a fraction of the total premiums received which equalled one month's coverage out of the total number of months over which the policies were issued?

A Well, the premiums earned in any one month would be the computation of the earned amount on all of the policies in force. It wouldn't have necessarily anything to do with the business written in a particular—a current month or a preceding month, but a number of months.

Q Okay. So that with respect to the policies written, the previous month, a fraction of the premiums earned on those would be remitted, as well as a fraction of the premiums earned on all other policies earned outstanding as of that time?

A That's right.

Q Now, from that figure of premiums earned, American Bankers would subtract the losses paid during the month?

A That's right.

Q And, would remit the balance to Consumer?

A This is on the accident and health, yes.

Q Was there any—was there ever any month in which the total of the losses paid for the month exceeded the premiums which Consumer was to earn?

A I don't know that I could say positively yes or [58] no. The business was profitable. So, that in most of the months there would have been a positive cash flow to Consumer.

Q And, is it your understanding that, whether or not such an event actually occurred—

A I do not know that it did.

Q All right. If it had, is it your understanding that under the treaty Consumer would have sent a check to American Bankers for the excess, so that it would discharge its one hundred percent liability for any claims which American Bankers had incurred?

A No, it would have been carried over against future periods.

THE COURT: But it would have been in any event an obligation of Consumer to American Bankers?

THE WITNESS: That's correct, yes.

BY MR. SCHWARZ: (Resuming)

Q You mentioned that one of the purposes for entering into the first reinsurance treaty was to permit Consumer to grow in its early years without having the kind of loss position that would occur if it were the direct writer, do you recall that testimony?

A Yes.

Q I would like to ask you a couple of questions to clarify just what this meant. You were given an [59] example, I believe, where $100.00 in premiums were received, and $50.00 in commissions were initially paid out, and I believe that the example referred to $20.00 in losses, leaving $30.00 of which a potential 15 percent contingent commission might be paid under a reinsurance agreement.

Now, let's assume no reinsurance for a moment. If the direct writer received $100.00 in premiums, its first obligation would be to set up an unearned premium reserve of $100.00, isn't that correct initially?

A Initially.

Q Initially. At the same time it would be obliged to pay $50.00 in commissions at the outset, is that correct?

A That's right.

Q All right. That's the normal practice in insurance, and in this type of credit insurance?

A Yes, generally.

Q Now, if an annual statement were prepared as of that date, let's say that all of this took place in December of the year, and an annual statement is then prepared, is it correct that the surplus would have been invaded by 50 in this example because you would be required to set up a gross unearned premium reserve of $100.00, you would have paid out $50.00 of the $100.00 in premiums that you received, leaving $50.00 that would have to reduce surplus?

[60] A That's right.

Q And, if that is all that happened, the company would be in a deficit position, assuming that it had no other surplus?

A Yes.

Q Okay. And, is that what you meant when you said that unless Consumer arranged its business under a reinsurance agreement, whereby it was the reinsurer, it could not have grown the way it did?

A That was an example in Consumer's case by reason of the design on the part of the company to build the capital of the company in order ultimately to become qualified in other companies. Consumer did not pay that advance commission in the early years. So, that the effect on consumer would have been only to the extent of the—the money retained by American Bankers, which was 12½ percent.

Q Well, then if Consumer had become the direct writer, and had not paid any commission, and also because it did not have reinsurance, would not have had to pay that reinsurance commission, then where would the deficit position come in that you referred to?

A Well, Consumer would have had some $400,000.00 in capital in order to become a direct writer. This the company did not have. The company was formed with $38,000.00 [61] capital.

Q So that—the reason for setting up is not so much the deficit position, but the fact that the capital requirement in—in Georgia, or the states where it was going to do this business, was much higher than another state?

A In Arizona, yes.

Q And, you waived the profitability of entering into a reinsurance agreement, and having to pay a 12½ percent commission against what it would have cost to accumulate the necessary additional capital, and I assume decided on the course that you took, is that correct?

A This is—this is what I understand. Remember, I indicated that I joined the company in 1959. So, that Consumer had—was in operations under the reinsurance treaty at the time that I came with the company, but

this is my understanding as to the reasons the method, the plan of operation to go into the insurance company as an Arizona company, was because of the small capital requirement, and it was done quite generally in the industry as I understand.

THE COURT: And, what did you understand the basis for the $400,000.00 capital requirement was, or would have been, had you gone the alternate route?

THE WITNESS: Well, the insurance laws of—of [62] states vary as to the amount of capitalization that is required for a company to write insurance policies in that state. For example, Georgia I believe is 200 200; North Carolina now requires us to have $600,000.00 in capital, and $600,000.00 in surplus. So, that with the—in order to write the business in certain states, where Southern was located, Southern would have had to have had an additional capitalization to have written business directly in the State of Georgia. So, this is the reason the reinsurance company approach was used in order to get into the life insurance business.

BY MR. SCHWARZ: (Resuming)

Q In what year did American Bankers begin to pay commissions to Southern Discount under the first treaty?

A I believe that it was 1959.

Q Do you recall approximately how much those commissions ran as a percentage of premiums?

A I believe that they were 20 percent.

Q Until that period began, was it correct that Consumers was earning the money which was later paid to Southern Discount as commissions?

A Well, Consumer was—was earning—was receiving the—the life insurance premium, less the American Bankers retention, and setting up the reserves, and earning this [63] —the profit on the life business over the lives of the policies.

Q I'm not talking now in terms of the timing of the earnings, but in overall effect, whether this was what happened?

A The end result was that yes, Consumer realized these earnings.

Q Now, once American Bankers began to pay commissions to Southern Discount, was it then in a position whereby it set up a gross unearned premium reserve of 100 percent of the premiums received, paid out 20 percent commission at the outset, and with respect just to those transactions, would have also been in a deficit position—

A Except that I believe that the contracts were amended to permit a pass through of that commission expense to Consumer.

Q How did that work?

A The contracts were amended to show that—that Consumer did in effect reimburse American Bankers for the—for the 20 percent commission.

Q Well, in a normal reinsurance treaty, the reinsurer will assume the liability for commissions as well as for the payment of claims, isn't that correct?

A Yes, um-huh.

Q If $100.00 in premiums are received by a ceding [64] company, and under a typical agreement, 97 percent of the premiums received will—will be the reinsurance premium, and let's say that the ceding company or the direct writer pays over that 97 to the reinsurer, from which commissions are then taken out, and claims ultimately paid, the direct writer will still set up an unearned premium reserve of $100.00, will it not, and then offset that by reinsurance premiums paid?

A Yes, um-huh.

Q Under the first treaty, the parties agreed that unearned premium reserves would be maintained by direct writer—I withdraw that statement. Would you look at Article 6 of Plaintiff's Exhibit 2, please, and tell me your understanding of its import?

(Pause.)

A Yes, I think that it stipulates who was to maintain the—the reserves.

Q Is it your understanding—

A Required by law.

Q Is it your understanding that Article 6 states that the—that American Bankers—it is your understanding that all this Article 6 says, is that American Bankers shall maintain any reserves required by—by law?

A On the accident and health business.

Q Do you understand this to reflecting an agreement [65] of the parties that it was American Bankers that would maintain the unearned premium reserve rather than Consumer on that business?

A Ah—I think that you would look to the contract to determine that—the way that I read that it states that American Bankers shall maintain the unearned premiums, the loss and other reserves required by law.

Q Well, if the law states who is to maintain the reserve, then wouldn't it be superfluous in this contract to say that the parties shall obey the law?

A Well,—except that—

Q What I am getting at, Mr. Born, couldn't the parties agree here, within your understanding of the —of the discretion allowed to companies, which enter into reinsurance agreement, that one company or the other might maintain the unearned premium reserve as part of their overall agreement?

MR. MASINTER: I object to the question, I think that the contract speaks for itself. This would be pure speculation and conjecture on his part as to what a contract could or might say.

MR. SCHWARZ: I'm not—well,—

THE COURT: Well, I thought that he was asking him about practice. This is—he told us that he is a lawyer. The question—would seem to me, relate to his [66] regular functions with, employment functions with the Plaintiff. I—I think that he would be competent to —if he—if he—

MR. MASINTER: If he knows.

THE COURT: Exactly, if he's short on an understanding, he can so indicate.

THE WITNESS: Well, I'm not sure that I'm an expert on reinsurance. But, companies quite often reinsure policy risks for financial reasons, and the terms of the contracts—the contracts that I have seen, and

have discussed with other people who have companies similar to ours, and insurance companies can by contract transfer their risk with the purpose generally to spread their risk over a longer period of time for—for capital reasons. Companies quite often in maybe December determine that maybe their capital is going to be impaired, and if they do not do something they might stand the chance of losing their license in a particular state, so that they would enter into a reinsurance arrangement to transfer this liability to another company.

THE COURT: And, that is what we understand, Mr. Born, but unless I misunderstand, all of that goes to the function of—of reinsurance arrangement as a means of transferring risk, and distributing risk, and all the rest of it. But, I thought that what he was talking about [67] was whether you had any impression either way that once a reinsurance arrangement was in force, so that the risk matters that you have just told us about have been redistributed in accordance with the parties wishes, then at that point is it your thought that the parties are free to determine and decide among themselves as to which of the respective risks they will maintain requisite reserves, are they free to do that, are they free to—ah—if you are the ceding carrier, and I'm the reinsurer, do you have an impression as to whether we are free, assuming that our reinsurer is going to take 80 percent of the loss, or 100 percent of the loss in this instance, is it your thought that, insofar as regulatory requirements are concerned, we would be left free to determine among ourselves who is going to maintain these reserves, assuming of course, that however we do it, we will wind up in the aggregate with a—with a total reserving of the risk exposure?

THE WITNESS: Well, I could perhaps answer that this way. It is my understanding that the regulatory—the regulatory authorities would require the—the reserves to follow the premiums. If you have the premiums, then you required by law to set up the reserves.

THE COURT: I see.

THE WITNESS: If you do not have the premiums, [68] then you—under the state laws, you would not be—now as a matter of—

THE COURT: I see, so it is your impression that reserve obligation follows premiums rather than reserve obligations following risk assumption, in the event that the two differed, the determinative would be premium receipt?

THE WITNESS: That's my understanding, yes.

THE COURT: I see. Right.

BY MR. SCHWARZ: (Resuming)

Q Do you know what unauthorized reinsurance is?

A Generally, it would be a company that is not authorized to reinsure, a contract company as a direct writer having a contract with an unauthorized—a company that is not authorized by law, not approved by the state regulatory authority as a reinsurer.

Q Could that reinsurer still be a competent, liquid company, but for any number of reasons might not be an authorized reinsurer in some particular state?

A This is entirely possible.

Q If a company entered into a reinsurance agreement with an unauthorized reinsurer, and remitted the reinsurance premium to the reinsurer, he—the insurance regulatory authority or the direct writer might still require it to maintain the unearned premium reserve if the reinsurer [69] was not authorized, isn't that correct from your understanding?

MR. MASINTER: If Your Honor please, I object to the question, and I don't think that it has anything to do with this case, and—

THE COURT: I—I'm inclined to—ah—agree that at least I don't understand affirmatively what it has to do with the case. What does it have to do with what he is testifying about, Mr. Schwarz?

MR. SCHWARZ: Your Honor, he made a statement as to his understanding concerning where the unearned premium reserve would have to be set up, that is—

THE COURT: He said that the reserve obligation followed premium payments or receipts, is that what you mean?

MR. SCHWARZ: Yes, and I am pursuing that principal which he stated, in terms of one situation, one where the reinsurance premium is transferred to a reinsurer, but where that reinsurer is unauthorized to do business in the state in which the ceding company is domiciled. That is a very common situation, and I'm asking him as to how he—what his understanding of the reserve reserve requirement would be in that situation, and my specific question was, isn't it your understanding that in that situation, the ceding company would still be required to show the [70] unearned premium reserve even though the premiums had been transferred to the reinsurer.

THE COURT: If you have an understanding, the—

THE WITNESS: Well, I do not really have a basis to answer, because I think that that would be a question of determination of whether or not the ceding company could take the reserve, it would depend upon the examining authority in the particular state. But, following the same statement, the unauthorized reinsurer having received the premiums would be required to carry the reserve, I assume. This is—

BY MR. SCHWARZ: (Resuming)

Q Would it be in the discretion of the regulatory authority in the ceding state to require it or not as it saw fit?

A Ah—I think under general regulations, the insurance commissioners have a certain authority to regulate the companies, and they generally review its contracts from a standpoint of financial soundness of the company for the benefit of protection to policy holders, and under certain circumstances, for many reasons, perhaps a particular state insurance commissioner could require a particular company to also carry those reserves, this—this I'm not certain of.

[71] THE COURT: I think that you are getting close to trying to push the witness into an expert status, Mr. Schwarz, so—there are going to be experts, as I understand it.

MR. SCHWARZ: I'm going to move on, Your Honor.

BY MR. SCHWARZ: (Resuming)

Q Would you state again the reasons Consumer had for entering into the second treaty?

A The second treaty came about because we—we had become licensed in Georgia, and later in North Carolina, and had made application for the State of Florida. The reasons that the reinsurance treaty was continued was because of the—the financial analysis which I made as to the effect on Consumer and on the company from its consolidated income standpoint, that if we wrote this business without continuing the insurance, there were considerations of the net profit, and also considerations of income taxes involved, related to the company.

So, that my overall analysis was that if we began to pick up all of the life business, and all of the accident and health, without a reinsurance company, it would cost us in terms of consolidating net income, considerable money, which I did not want to reflect because of the large volume of borrowings that Southern Discount Company regularly made.

[72] From a financial standpoint, it was my responsibility to plan the affairs of the company so that from an accounting standpoint the—well, I didn't feel that I was called on—upon to arrange or not arrange the reinsurance, whch would have resulted in a reduced profitability in financial statements thereby limiting the amount of funds that we could borrow.

Q You would agree that you were entitled to arrange your affairs so as to make as much money as you could?

A Yes.

Q And, that if tax considerations contributed to that, you were also entitled to take those into consideration?

A Yes.

Q Am I correct that you still intended to continue the assumption of 100 percent of the liability that arose under the policies that were issued, as between you and

American Bankers, and that it was just a question of rearranging the financial affairs of the company so as to maximize the profitability of doing that?

A That was the result, yes.

Q Is it correct that even as you entered into the second treaty, the first treaty remained in operation with respect to policies that were in force at the time of entering into the second treaty?

[73] A Yes, it did.

Q And that that treaty remained in force until all the policies that were in force at the time of the second treaty had expired in their normal course, is that right?

A Yes.

(Pause.)

MR. SCHWARZ: Your Honor, if I may just have one minute, I think that I—

(Pause.)

BY MR. SCHWARZ: (Resuming)

Q I just have one more question, Mr. Born. Under the first treaty, is it your understanding that if—that if American Bankers had become insolvent, the reinsurer would still be obliged to pay claims that arose under the policies?

A Yes.

Q If the unearned premiums were being held by American Bankers, where would the reinsurer get the funds to pay those claims?

A Well, you would have had the accountability for the unearned premiums. If American Bankers was insolvent, the—on the life business, there is no question but what Consumer had the funds and was liable. But on the accident and health, Consumer's liability was limitted to the monthly earned premium.

[74] So, that had American Bankers become insolvent, I would assume that as losses were incurred, that Consumer would under the reinsurance treaty been required to pay those losses, which would have had the same effect really of spreading the losses out over the expiration date of the policies.

Q To Consumer's—

A I assume that, yes, Consumer would have been liable.

Q I see. There was no limit to Consumer's liability under those provisions, is that your understanding?

A I think that that is right, yes.

MR. SCHWARZ: I have no further questions, Your Honor.

THE COURT: Redirect.

REDIRECT EXAMINATION

BY MR. LANDON:

Q Mr. Born, let me ask you one question solely. The counsel for the Defendant referred to a three percent guaranteed commission, which was paid, was that in fact a guaranteed three percent commission at the time of the treaty being written?

A That was an agreed rate.

Q Was there any way that that three percent [75] could have varied based on the loss ratios, the loss profitability that in fact occurred?

A No, we might have tried to negotiate it lower, but insofar—insofar as the—contract it would remain the same.

Q The three percent figure, right, had the money been there, had losses increased to an extent that they would have exceeded 97 percent for some reason with the commissions, and so forth, would that three percent have been affected by that fact?

A Well, I think that American Bankers would have been liable for 80 percent of the risk, and could conceivably under those circumstances, it could have wiped out their three percent, yes.

A And, that would be in effect to some degree in addition to the capital reasons, which you gave for making the determination under the second treaty—

A Yes.

Q And, other consideration would have in fact resulted in some risk sharing to that extent, were—had

those events occurred, which apparently they did not during that time?

A That's right.

MR. LANDON: Thank you.

THE COURT: May I ask for my own edification, [76] are you contending that Consumers loss liability as a reinsurer of these risks was to any extent affected or reduced or limited by the amount of premium dollars that it got at any one time?

MR. LANDON: Your Honor, I am not one to interpret the exact words of that contract. Mr. Born mentioned the 1959 amendment, which stated that it was limited. I think that the—

THE COURT: Well,—but I am putting that to one side. Now, I would just like to be clear about what—about what you are contending here, because frankly, I—he is a very knowledgeable witness, and he seems to be completely forthright, but I feel that I am with him, I'm following everything, and then he'll make a remark like he did here just a minute ago, well, yes, up to the extent of the premiums they got. And, then, I think to myself, well, apparently I didn't understand him.

Now, can't you tell me what you're contending, as to this risk liability, is it affected by the amount of premium dollars that Consumer receives as a reinsurer, as distinguished from a contractual covenants assigning or apportioning risk, as such, and not premium dollars?

MR. LANDON: Ah—I think—what I gather your understanding is is the correct—and as Mr. Born explained, the distinctions were as to the settlement, the [77] times of payment, and that sort of thing, but did not affect the—

THE COURT: Fine.

MR. LANDON: That is my understanding.

THE COURT: Now, what I meant is, just a minute ago when counsel was asking him about—well, suppose American Bankers went broke, became insolvent, would Consumer not have to come up with any risks incurred, or losses experienced, and then I thought he said yes, up to the amount of the premiums they had gotten.

Well, that set me back again. Now, as I understand it, if you disregard when they have to make this payment, and just focus on whether they have to make good these risks, there is no question but what Consumer as a reinsurer in A&H and credit life had to come up with 100 percent of the risk exposure, is that right, Mr. Born?

THE WITNESS: That's correct, yes, sir.

THE COURT: At some time or another?

THE WITNESS: That's right.

THE COURT: Okay.

MR. LANDON: That concludes my redirect examination.

THE COURT: All right, anything further?

RECROSS EXAMINATION

BY [78] MR. SCHWARZ:

Q I just want to pursue that point one short step further, regarding the three percent figure under the second treaty, three percent commission that American Bankers was to receive. Isn't it correct, Mr. Born, that that three percent was a fraction of the reinsurance premium that was payable to American Bankers, and not a fraction of all premiums received by Consumer as the direct writer?

A It was a fraction of the earned reinsurance premiums being 80 percent of the—of 100 percent of the premiums, three percent of that figure.

Q If in any month the loss experience with regard to the portion that was reinsured with American Bankers exceeded the earned premium, isn't it your understanding that that negative balance would be carried forward to the next month?

A Yes.

Q So, that American Bankers would still get its three percent out of that premium, even if that loss total was greater than the premium earned?

A In a particular month. But his—the example was, that if you had a 97 percent loss ratio, then you would

at that point—American Bankers would begin to lose that three percent.

[79] Q Would you explain—well, if in any month the losses were—in any month the losses would have to be 97 percent of what in order for American Bankers to lose that three percent?

A Well, American Bankers received 80 percent of the premiums, so, insofar as American Bankers are concerned, the loss ratio—it really wouldn't have made any difference rather it was 97 percent of 80 percent of the premiums, or 97 percent of 100 percent of the premiums, because the amount that American Bankers was to reimburse Consumer was—was 80 percent, so the minute 80 percent of the losses payable by American Bankers exceeded the 97 percent of 80 percent of the earned, then American Bankers would have had a loss.

Q I—I thought that we had clarified this, but your answer suggests that we haven't, and I think that it ought to be clarified at this point. I hand you Exhibit number 3, Mr. Born, and ask you to summarize your understanding of Article 6 of that Exhibit, which is headed experience refunds?

A The experience refund to Consumer Life Insurance Company would have been the earned reinsurance premiums less a reimbursement of the earned reinsurance commissions, less three percent expense profit.

Q Now, that is the three percent that we are [80] talking about here, is that correct?

A That's it. And, less incurred reinsurance claims during the calendar quarter.

Q Now, would you read paragraph 2 of Article 6, first, and then tell us your understanding of it?

A And, if the foregoing formula is negative for a given calendar quarter, such negative amount will be treated as an addition to incurred claims in calculating the experience refund for the following calendar quarters.

Q Is it your understanding that under that provision, in any one month, whether that result is positive or negative, American Bankers will get its three percent, and the only month—I end my question there, isn't it correct that first the three percent due to American Bank-

er comes out, and then everything else is subtracted, and if there is a negative result it is carried forward to the next month. So, that the only time that Consumer—that American Bankers could ever lose anything would be at some termination point if there is still an excess, and the treaty doesn't say what would happen under those circumstances, does it?

A There is an amendment to it, that says that that will be dropped after 20 quarters.

Q So, that the negative figure would have to be carried forward for 20 quarters in order for it—

[81] A And, it would not be charged against this—against this refund.

Q All right.

A American Bankers would have had it.

Q Wouldn't you say that as a practical matter, it was virtually impossible that the experience under this treaty would ever produce a loss of that three percent even for one quarter to American Bankers?

A Based on the volume of business, and the loss ratios of—of the business, which was the subject of this reinsurance, it was unlikely that American Bankers would have had ultimately to pay a loss. But, that can only be determined as it relates directly to the loss ratio on the business that is involved.

But, if you had a catastrophe or any other reasons, where the loss ratios—claims went real high, went to the 97 percent, then American Bankers would have been in a position to have loss exposure, and would have had to pay those losses.

Q In setting the three percent figure that Consumer agreed to pay American Bankers under this agreement, would you say that the possibility of—of the amount that was going to be paid to American Bankers being actually used to pay claims was an extremely minor consideration in setting that figure?

[82] A Well, that was a generally competitive rate for this type of contract, and that really would relate to the—the parties analyses of the—of the transaction as to what the—the long term risk exposure would be.

Q All right. Before the amendment was made, the three percent was not subject to any risk at all, isn't that

correct? Because the negative figure would be carried forward indefinitely?

A Well, you would have to accumulate the results of the formula computation. If you got into a high-loss ratio, with the last factor being negative, more than off-setting the earned premiums, then I could—I could see a condition not in Consumer's case because of the volume of business involved, but I could see a certain circumstance under which American Bankers would have a loss situation, and would lose that three percent.

Q But, you are saying that at the time that this treaty was negotiated, in view of the experience that Consumer had thus far under the earlier treaty, within the industry, there was not that—

A That's right. The loss ratio of the type of business was—was well known to both parties.

MR. SCHWARZ: I have no further questions, Your Honor.

[83] THE COURT: Anything further, Mr. Masinter?

FURTHER REDIRECT EXAMINATION

BY MR. LANDON:

Q I ask him to repeat—Mr. Born, didn't you say that this sort of contract was customary in the industry, and that this was a competitive rate that was used?

A Yes.

Q And, the point being that I think that counsel was raising, was whether or not this was—this possibility of loss based on an extremely high loss ratio, was an inducement to the contract, it was nonetheless a fact, a possibility did exist regardless of its remoteness, or whatever was that what your statement was?

A Yes.

MR. LANDON: That's all the questions.

THE COURT: Was this American Bankers outfit a total stranger to both Southern Discount and Consumers in the terms of any ownership attributes?

THE WITNESS: Ah—I guess that the two companies had done business over a number of years.

Southern had acted as agents for American Bankers prior to the formation of Consumer Life. American Bankers at one time had a small interest in Southern stock, but that was later disposed of. So, that in terms of the [84] negotiations between the companies, American Bankers was an independent company at all times, with Southern having no incident of ownership in American Bankers as such.

THE COURT: Or vice versa after the liquidation of the stock to which you just referred?

THE WITNESS: That's right.

MR. SCHWARZ: Your Honor, may I just ask one question or two about that stock interest, which I forgot to ask on my examination?

FURTHER RECROSS EXAMINATION

BY MR. SCHWARZ:

Q Is it correct, Mr. Born, that the—that American Bankers owned 2½ percent of the stock of Southern Discount from March 15, 1962 until March 25, 1969, and approximately an additional 1 percent acquired in 1972, which it held until February of 1973?

A Yes, it is.

Q March 15, 1972 was about a month before the second treaty, is that your understanding? The second treaty was—

A That's—I'm sure that that is correct.

Q Was the—was the stock acquisition acquired in connection with the renegotiation of the treaty arrangements between the two parties?

A No.

[85] Q What were the loss ratios under the first treaty, what range did they actually cover, do you recall?

A Do you mean as to life or accident and health?

Q As to life and accident and health.

A The loss ratios on the life, and this would be based on—I guess an accumulation of the figures over the period from 1957 until on in through 1963 or 1964, would have been in the range of 23 to 24 percent of—give or take two or three percent, and based on—

Q Of the premium charged?

A Based on an earned premium basis. On the accident and health, the approximate loss ratio would have been in the area of 30—30 percent approximately—28 to 30 percent.

Q Is that approximately the ratios that were experienced before these contracts were entered into in 1957?

A I have no information on what the loss ratios were prior to that time.

MR. SCHWARZ: No further questions.

THE COURT: Mr. Masinter?

MR. LANDON: No further questions, Your Honor.

THE COURT: Thank you, sir, you may be excused.

(Witness excused.)

[86] MR. MASINTER: Your Honor, we are ready for our next witness, it might help if you would give some idea as to what time you want to recess for lunch?

THE COURT: Whatever your pleasure is. It makes little difference to me, around noon or anytime thereafter that you get to, you might begin with him, and when you get to a point that you feel is convenient or that you want to regroup, or for any other purpose, why just indicate that you would like to recess.

MR. MASINTER: All right, fine. A. C. Eddy, Jr. will be our next witness.

THE COURT: Raise your right hand. Do you solemnly swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you God?

THE WITNESS: I do.

THE COURT: Be seated.

THE REPORTER: Please state your name and address for the record.

THE WITNESS: My name is Arthur Crooks Eddy.

THE REPORTER: Would you spell it please?

THE WITNIESS: Arthur, A-r-t-h-u-r, Crooks, C-r-o-o-k-s, Eddy, E-d-d-y.

THE REPORTER: And your address, please.

THE WITNESS: 3167 Linden, L-i-n-d-e-n, Road, Rocky River, Ohio, 44116.

[87] THE REPORTER: Thank you.

ARTHUR CROOKS EDDY, a witness produced on behalf of the Plaintiff, having first been duly sworn by said commissioner, was examined and, in answer to interrogatories, testified as follows:

DIRECT EXAMINATION

BY MR. MASINTER:

Q Mr. Eddy, what is your present occupation?

A I'm a consulting actuary.

Q How long have you been engaged in that nature of work?

A In being an actuary, I've worked for approximately 25 years, and consulting work for about 13 or 14 years.

Q Would you please describe the nature of the services that you perform as a consulting actuary?

A Well, the services are three general categories. One are advisory services in the area of life insurance company management problems, life insurance company administrative problems, accounting, taxation and tax paying, or in data processing, rate making, reserve calculations, annual statement work, things of that nature.

MR. SCHWARZ: Your Honor, in the interest of time, we would stipulate to Mr. Eddy's qualifications as an expert.

MR. MASINTER: Okay, thank you.

[88] THE COURT: Well, excuse me, I guess I would ask for my own illumination, an expert on what?

MR. MASINTER: I was getting to that, Your Honor.

THE COURT: All right.

MR. MASINTER: I was going to go into some questions also about his background as an accountant. He indicated that he performed some services with respect to the income taxes and accounting type matters.

BY MR. MASINTER: (Resuming)

Q Does an actuary perform accounting work also?

A Yes, for life insurance companies to the extent that

life insurance accounting is somewhat generally—different from general accounting, and differs from the AICPA's interpretation of general accepted accounting principals as far as their annual statement of reporting. It involves the type of bookkeeping which the actuaries refer to as an incomplete system of double entry bookkeeping, and that has to do with how a company's develop and account for—on their statements, their major liabilities, namely their policy reserves. And, calculations of policy reserves involve life contingency mathematics, which are generally the type of mathematics—well, specifically the type of mathematics which actuaries are compelled [89] to learn and to understand.

So, that particular function in life insurance companies is generally delegated to actuaries to perform. And, this frequently encompasses the assistance in or the completion of their annual statements, and also tax returns.

Q In order to become a member of your professional association or society, do you have to study accounting or take specific examinations in accounting?

A Yes, an actuary does have to have passed examinations in his subjects.

MR. MASINTER: We will submit, Your Honor, that the stipulation as to Mr. Eddy's expertise runs to his qualification as an actuary, and also his qualification as to accounting matters, insofar as they relate to insurance company, examinations, and the types of things that Mr. Eddy just testified to.

THE COURT: I see. Is that understood by the Government?

MR. SCHWARZ: That's satisfactory.

THE COURT: All right, that will be so stipulated.

BY MR. MASINTER: (Resuming)

Q Mr. Eddy, would you describe briefly the general method of regulation of insurance companies that is in effect [90] in the United States?

A Well, insurance companies are for the most part regulated by several insurance departments; the insurance laws and regulations of the various states in the United States.

The extent of federal regulations is very minimal and generally is restricted to federal income taxation.

Q Are these regulatory requirements uniform or consistent in any way?

A The—the insurance statutes of most states are quite similar, and especially with respect to things such as policy and contract liabilities and reserves, and this is mostly through the efforts of the National Association of Insurance Commissioners, which has been in existence for many decades, and through their concerted efforts, and their various committees and sub-committees, they have developed various guidelines, which led to very much uniformity, as far as legislation and as far as rules and regulations promulgated by the insurance departments of the several states.

And, there are differences, of course, and no two states will be precisely the same in all respects, insofar as their regulations. But, there is a thread of uniformity in many of the important areas.

[91] Q How do the states conduct examinations of insurance companies?

A The—the Commissioners have divided the United States into several districts, encompassing states,—adjacent states, in these various—and these are called zones, and the—

Q What are they called?

A Zones.

Q Zones.

A And, the insurance companies domiciled in a particular zone are generally examined by representatives from the insurance departments, comprising the states of that zone. And, the chief examiner is generally an examiner from a state that the company is domiciled in.

Frequently states who have a major interest or a large number of policy holders in a company outside its zone, may still be represented in an examination.

But, generally speaking the examinations are performed within the zone, by the zone states or representatives from the zone states.

Q Well, let's take for example a company that may be doing business or contacts with eight or ten states, and suppose the eight or ten states lie in two different

geographical zones, how would an examination come about, who would appoint the examiner?

[92] A Well, the—the selection of examiners for an examination depend first of all on the influence that the chief—in the home state examiner—and the chief examiner, and availability of those other examiners who would be free to help an examination, and who are also interested in a given company. And, then, also, the consideration of the volume of insurance business in a given state would have some influence on that state's interest in participating in the examination.

THE COURT: Mr. Masinter, maybe I misunderstand the definition of an actuary, but his stipulated expertise is as an actuary, and one versed in insurance accounting principals, now does all this business about regulatory practice, and what not fall under one or the other or both of those umbrellas, and if so which?

MR. MASINTER: Well, I think both, Your Honor. I think that the actuary is the—the only perculiarly qualified to respond to all of these matters that relate to insurance companies, certainly a lawyer is not, I'll tell you that.

THE COURT: Well, maybe I—right, well, maybe I misunderstand what an actuary—I always thought that an actuary was a fellow who told him what risks you were going to assume, and he was supposed to tell you how much you would have to lay away to defend that, and I didn't [93] know he had anything to do with regulations.

MR. MASINTER: I would suggest that it might be appropriate for Mr. Eddy to—to describe for the Court exactly the functions that an actuary does.

THE COURT: All right.

MR. MASINTER: I think that that would be appropriate.

THE WITNESS: Well, it might be a little difficult for me to mention all the various things that one is required or called upon to do, in the actuary profession. But, they do encompass dealing with insurance departments, both in determining or developing policy forms, the policy contracts themselves, reinsurance contracts.

Then the question of reserve calculations, and certification of reserves, as a consulting actuary, one frequently represents insurance departments in the certification of reserves, as a representative of the insurance department, which is a role that I have performed on occasions.

We also are required to be familiar with the valuation requirements, and the reporting requirements of the states in which our companies are operating.

MR. MASINTER: Does that—sufficiently—

THE COURT: I—I think that I understand [94] his exposure, I—I just don't want you to be mislead—frankly it would seem to me that if you all—now maybe this is not going to occur, but if you all got into some controversy—some viable controversy about what a particular jurisdiction required, I don't think that this man, and his thoughts on that subject would be particularly probative to me as opposed to going to what I would consider the horse's mouth, that is someone competent to speak for the jurisdiction in question.

Now, maybe you all don't—you know, aren't going to encounter that kind of—of thing, but I don't see where he is—well, he spoke about reserves for example. I can understand where he could—would have expertise in matters of reserve computation, and—ah—derivation or the like, but I don't understand that he would have expertise in something that went to the question of the prescription of a reserve, or why something of that sort would be required and if required the extent to which it is required, and all of those kinds of things.

MR. SCHWARZ: Your Honor, I—

THE COURT: But, you may not have any problem along those lines.

MR. SCHWARZ: In terms of what we have stipulated to, I think that it might be appropriate for me to make one statement in that regard.

[95] THE COURT: All right.

MR. SCHWARZ: Mr. Eddy, has had a great deal of experience in connection with the filing of annual statements, and from that experience he would know what

some insurance department accepted in a certain case, and what it didn't accept in certain cases within the realm of his experience.

I would not object to—to his stating the results of his experience in that regard for whatever it is worth.

THE COURT: Well, all right. All right, but in that capacity, he would be speaking as a fact witness, as I understand it, and not an expert. Isn't that right? I just want to be sure that you are not mislead.

MR. MASINTER: Well, if Your Honor, please. I think that, that the capacity of an actuary as an expert in matters relating to insurance company regulations does go to the question of—of the requirements for reserves, the—the respective regulatory requirements of the various states in which their clients do business. I think that this is quite properly the subject matter of a consulting actuary, and one who is an expert in his field.

THE COURT: Well, all right.

MR. SCHWARZ: Your Honor, I limited my—my stipulation—I would like to limit my stipulation to [96] that kind of testimony, and the reason that I stated it the way I did was because if questions were posed saying what would the insurance departments do or would they permit thus and so, I don't think that Mr. Eddy is qualified to say what Arizona would do or what another state would do. He could say that as an expert having covered a lot of audits of this type, he had known that it has been done. To that extent an argument, an argument can be made that that was the policy at the time.

But to say that in this situation which he is not familiar with, based on his understanding that their policy is this or that, I don't think that he is qualified to testify to that.

THE COURT: I think maybe that's a decent example of the kind of thing that I would have in mind, Mr. Masinter. If for example, it were germane as to what Podunk required with regard to particular insurance, his opinion in the matter, as against a man who is—works as the chief administrator of—of Podunk's program in this particular, why I would—

MR. MASINTER: I have no difference as to that, Your Honor.

THE COURT: All right, fine.

MR. MASINTER: I think that Mr. Eddy is qualified to testify as to his general experience in [97] matters of this nature. As to precisely what the State of Florida, and the State of Arizona, and the State of Georgia did in this particular instance is clearly a matter of record. It is reflected in the annual statements, and in the reports of examination conducted by the various insurance departments.

THE COURT: All right. So he is going to talk about what you might call generally industry practice.

MR. MASINTER: General industry—

THE COURT: As he understands it?

MR. MASINTER: That's correct.

THE COURT: All right.

BY MR. MASINTER: (Resuming)

Q Mr. Eddy, let me ask you this, in what states do your clients conduct business, at the present, and over the past ten years, what states generally have you been familiar with?

A Well, most of the contiguous United States—the states of the United States. And, I don't know of any offhand that I didn't deal with. But I can't be absolutely certain right at the moment.

Q When you deal with the regulatory authorities, what type of matters do you become involved with, and what is the general nature of your experience and expertise in dealing with the regulatory authorities?

[98] A Well, the most common encounters are dealing with the policy forms, the reinsurance forms, reserve certifications, valuation reports, and on company examinations, and consultation with examiners at various companies while on examination about various details to be handled or reported in their own reports—their examination reports.

Q What is a reserve certification on valuation?

A Well, the—various insurance companies have their reserves certified by the home state, and when they are operating in more than one state—under one state's jurisdiction, they generally are required to get a certification of the reserves which they report in their annual report, certified by the insurance department of their home state, as to its sufficiency and accuracy, and this is then submitted with their filings to the other states in which they are operating or licensed.

Another type of certification is the one required by a number of states, within the last few years, and a growing trend, in that the insurance departments of the several states are now requiring a certification of reserves to be performed by independent actuaries for the companies domiciled in their own state, which is a second type of certification.

Q Tell us how that type of certification comes [99] about, and what role an actuary would play?

A Well, it's—it's a growing problem in the insurance industry, and I presume, to—to be able to accept the reserve reported by the 1800 odd companies without some assurances that they have been—the reserves themselves have been examined by someone qualified. And, this—there maybe six or eight states now—maybe ten states who in order to satisfy themselves that this examination has in fact been done, they are requiring an independent certification, someone not on the company's staff.

Q Is this the type of work you might do?

A Yes, I have done that type of work.

Q In what states have you performed this type of certification?

A Ah—Ohio, South Carolina, New Hampshire, I'm not sure what others at this moment.

Q But more than just one or two?

A Oh, yes, right.

Q Do the state insurance departments accept generally the certification performed by an independent actuary, or do they perform their own examination report?

A Well, to the extent—this is a new requirement, you understand, for independent certifications, that is a new requirement of the insurance departments. So, it—there is a little experience to call on for that. [100] The insurance departments though who haven't and don't—they have sufficient staffs to do their own certification work, do employ consultants, and in the last 12 or 13 years as a consultant, I have been either independently or as a representative of a firm, which has performed certifications for a number of insurance departments.

Q So actually you have worked for an insurance department as well?

A I have, yes, sir.

Q So, it might be possible for any insurance department in any state in the United States to come hire you, is that—and you would perform independent work for them?

A Well, they do—do hire independent consultants, I'm sure that a number of states do.

Q Mr. Eddy, would you tell us if you are generally familiar with what is meant by credit life insurance, and credit accident and health insurance, would you describe that for us?

A Yes. The credit insurance policies are essentially designed to protect the debtor or the creditor for the balance of his indebtedness in the event of his death or his disability.

And, the benefits provided by the general type [101] credit insurance contract is to pay the amount of the unpaid indebtedness on death to the creditor, if there is any excess payment that is paid to the beneficiary of the debtor.

And, in the case of the accident and sickness benefits, the general benefit is to—to make the monthly installment payments while the debtor remains disabled. If he should remain disabled until after all installments have been paid, then that terminates the insurance. If he recovers or dies before the terminative period then that would terminate the payments also.

Q Would you describe for us generally how the credit insurance grew and developed in the United States?

A Yes, sir. Credit insurance was by most standards practically non-existent at the end of World War II. In fact in 1945 there was some $400,000,000.00 of credit insurance in force in the United States life companies covering about 2,000,000 people.

By the end of 1971, that had grown to be more than $114,000,000,000.00; covering some 99,000,000 people.

Now, this insurance grew, and that information you can find in the life insurance fact book, which is published by the Institute of Life Insurance. I'm quoting from the 1972 publication. The 1973 publication would have more up to date figures than that.

[102] Now, this business grew, power in growth, the growth in consumer financing, which I'm sure that most people in business realize, gots its fresh start and impetus after World War II also.

I don't know—have I answered your question?

Q Would you tell us the main companies that were involved in this industry in the early development and throughout the development of it?

A Well, in the earlier days of credit insurance, the pioneering companies were companies such as American Bankers, companies like Old Republic out of Chicago, American National out in Texas, Pilot Life Insurance Company, a former employer of mine, and a number of other fairly large companies, with substantial diversity of products—insurance products.

But, these companies were the ones who really initiated the credit insurance programs. And, they recognized the saleability of credit insurance, and developed the products as the consumer financing grew.

In the early days of credit insurance, the insurance was really sold by these companies, the policy forms were theirs, and they simply used the finance institutions, the loan offices, or an individual in the loan offices, or the banks, in the case that the banks were involved in credit insurance, as their agents. And, they [103] paid generally they paid a commission to the financing institution through those individuals.

And, they were then the only insurance company involved in the operation. It wasn't too long after the beginning of the large great growth of credit insurance though that insurance companies or the financial institutions such as Southern Discount here recognized that they were not getting all of the profits from the operation, and that they in fact were the economic powers that generated the—the insurance opportunities—the insurance sale opportunities.

And, as a matter of fact, and something easily substantiated, there was a great growth in small limited capital insurance companies organized during that period of time, starting in the late 1940's, going into the 1950's, in the State of Arizona.

For example, currently there are about 350 life companies in Arizona, most of which are of the Consumer variety, domiciled there, out of 1800 companies in the United States. In fact the insurance in force in Arizona represents maybe about something less than one percent of the insurance in force in the country, and that is total insurance, all types. And, yet 19 percent of the insurance companies are domiciled in the State of Arizona.

[104] And, it was due to the fact that this economic power generating credit insurance sales, was translated into ownership of insurance companies by these economic powers. And, they started off with the limited amount of capital that was required. Arizona required actually $37,500.00 of capital and surplus to start a life insurance company, $25,000.00 in capital, and $12,500.00 in surplus.

And, for the most part, companies like American Bankers—the companies that were the pioneers in the credit insurance business were faced with either cooperating with and helping create these small captive companies or else lose the business completely, because many of these financial institutions were quite capable of establishing insurance companies to sell their own insurance.

But, American Bankers as an example of the pioneers, they started these operations or assisted in the start of them, by offering the policy forms, and doing

the administrative work, as they always had done, and yet in order to allow the companies—these financial institutions to participate in the life insurance earnings of the life insurance portion, then they passed on whatever part of the business they were required to under the competitive pressures of the other pioneers, to keep as much of the earning's capacity of the insurance as was [105] possible.

In this case they were passing on the insurance program to Consumer with an 12½ percent charge for their function, which included the policy forms, and the administrative work, and of course for their profits,—their earnings.

Q In your experience, then, this was a fairly widely accepted and common type of practice for finance companies and institutions to form their own—

A Right—well, having worked with Pilot, which was one of these companies pioneering, they had dozens of this similar situations, and of course as an actuary with that company, it was one of my jobs to be—connected with that program, and working with that program, and then also in the consulting work, most of these companies did require consulting actuaries to do—to help complete their annual statements for one thing, and other matters too.

MR. MASINTER: If Your Honor please, I think that this might be a good opportunity to stop for lunch, and because we are ready to get into another subject, and we would like to set up a little projectory of a chart, and we would like to have Mr. Eddy describe, and this might be a good time to do that.

THE COURT: Very well, we'll recess and reconvene [106] at 1:30.

MR. LANDON: Have you any preference, Your Honor, for where that screen should go?

THE COURT: Well, no, wherever, you—you might put it over there somewhere.

(Whereupon, the hearing in the above was recessed at 12:10 p.m., as described above.)

[107] AFTERNOON SESSION

THE COURT: Will you resume the stand, Mr. Eddy? I remind you that you remain under the oath administered at the outset of your testimony?

BY MR. MASINTER: (Resuming)

Q Now, Mr. Eddy, before you recessed for lunch, we were talking generally about the insurance industry as relates to Consumer Finance industry and the fact that it was common in the 1950s or the period after the war for companies that were engaged in the finance business to form their own captive or limited capital insurance companies, as you call them.

Now, Mr. Eddy, why was it common for these companies to be engaged or was it common for these companies to be engaged in just reinsurance or did they engage as direct writers in many of the states or do you have experience or knowledge as to that?

A Yes, my experience in that is that at the outset of these large number of companies that were formed in the State of Arizona with 37,500 capital generally were companies that were established by business enterprises which had their business interest, main interest and namely the finance consumer finance business located elsewhere. I mean Arizona was simply chosen as the state because it amongst the several states had the lowest [108] capital requirements and then the only way such companies could participate in insurance sold to customers in their own finance business territory would have been through some other insurance company as the issuing company which would in turn cede reinsurance to them as a reinsurer and that in fact is what happened in most of these—well, in essentially all of the cases that I've had experience with and they number quite a few.

Q Why couldn't they have become qualified to write the insurance directly?

A Well, as an example, for Consumer, for them to have been able to have written directly in their main

territory which I believe to have been the State of Georgia and maybe the southeast, they would have had to have had a company licensed, either domiciled and licensed or licensed in the southeast or in that territory. Well, in those days the requirements of all the states in the southeast were substantially greater than the capital requirements, were substantially greater than the capital requirements of Arizona, and there was a question and it was with quite a number of these companies that I have had the opportunity to work for one way or another, it was generally their interest to minimize their capital invested in this business. For one thing, the capital and surplus of a life insurance company, even these limited [109] capital companies in Arizona and their policy reserves—or the assets representing their policy reserves are limited as to what investments they may be placed in, limited to fixed dollar type investments generally which carry with them substantial guarantees of principal, relatively speaking with quite relatively low rate of return. I think Mr. Born said earlier this morning that Southern Discount, and my experience is true of all these finance companies that I had worked with, they were in the business of borrowing money in order to relend it and they were paying pretty high interest charges for the money they borrowed and in fact, during that period of time, it is my recollection and belief that they were paying seven or eight percent as sort of the minimum to borrow money to put in the finance business.

Well, it would have been right foolish for them to have taken that money or much of it to invest in capital and surplus of a stock life insurance company which had limited return and they would in fact be losing the difference between what they had to pay to borrow money and the amount of return you could get on that type of investment permitted to life insurance companies.

Now, I think those are the several reasons or at least a couple reasons why they went to Arizona and why they had limited capital. Another thing to consider [110] and certainly was considered by a number of clients that I've worked for was the fact that although the consumer

finance companies were the agency for us for selling this business, they really didn't have generally speaking any administrative procedures' facilities and they certainly didn't in the outset have things like policy forms which not only have to be drafted but approved and printed and that sort of thing, but it was a service that was being performed, but mainly my opinion was that the consumer finance business, generally speaking was interested in going in insurance business for this credit insurance and for the additional profits it might get by being in that business, other than just as an agency, and that the reinsurance route was in part sold to them by the more established pioneering companies who and I know a number of the gentlemen who were in those companies at that time who were really concerned about trying to keep as much of the credit insurance profits or income as they could, so this was sort of a joint venture and joint interest for them to help establish such limited capital companies because they kept them in the picture for a longer period of time.

Q In your experience, what would be the average rate of return during the years in question on the reserves invested by insurance companies?

[111] A Well, quite generally actuaries were assuming that for purposes of calculation, premium calculation premium rates for other types of insurance, four, four and one-half percent average return.

Q So that if companies that earned higher rate of return, it would be—what you're saying is that it would be foolish to go from a higher rate of return to four, four and a half percent rate of return.

A Right, because that's just another part of the question of capitalization considerations and one being you don't have to have as much money and two, if you put much money in at the risk of loss of higher return on money than that's an additional capital consideration in my opinion.

Q How are credit life insurance policies and A and H policies issued, master policies or individual policies or groups, generally speaking?

A Well, credit insurance is issued both as directly individual policies, issued directly to the individual from the company that's issuing it, the insurance company and also it's issued through a group contract between the insurance company and the creditor with certificates being issued to the individual debtors. Now, at this time in the United States about ten percent of the volume by number of lives and the amount of insurance in force, is on the [112] individual basis and about 90 percent is in force on the group basis.

Q Turning your attention now, Mr. Eddy, to the concept of reserves could you explain in your opinion what is meant by the term life insurance reserves and also what is meant by the term or phrase, accident and health reserves or unearned premium reserves as they relate to accident and health insurance?

A Yes, first of all reserves at time in general implies to me two separate and distinct items which may be further subdivided. You have at any point of time in a life insurance company a reserve for benefits which have already been incurred. If you have that chart, we may want to look at it.

MR. LANDON: If it please the Court, we will put this chart on for Mr. Eddy's—

MR. MASINTER: If Your Honor please, we tried to simplify this as much as we could because of our purposes really because we had a difficult time understanding a lot of the concepts, so one thing that we chose to do and what we would like to do is to have a chart while Mr. Eddy answers questions so that he can direct the Court's attention to diagrammatic sketch of the words he's going to say. We thought that might simplify it. Now, this is not in the form of documentary evidence and it's [113] merely in the form of further explanation.

THE COURT: To illustrate his testimony, but nonetheless are you going to put in the record—

MR. MASINTER: Copies of it?

THE COURT: Copies of it?

MR. MASINTER: Yes sir, we'd like to introduce copies if acceptable to the Court and to counsel, but it is not in the real sense documentary evidence, but just by way of illustration of his testimony.

THE COURT: I think for that purpose and it's so understood, there's no objection, is there, Mr. Schwarz?

MR. SCHWARZ: No, there's not.

THE COURT: It's illustrative of the witness. It's not to be taken as evidence of itself, but rather illustrative of the witness' testimony.

MR. SCHWARZ: No, we have no objection on that basis.

THE COURT: All right.

MR. MASINTER: Shall I turn this—

THE WITNESS: It's easier to see if you do.

A At any point in time on that illustration on the screen concepturally represents the two types of reserves which an insurance company would hold at any point of time, the valuation date which is the point about the center of the horizontal line and if you would think [114] in terms of this just representing one single policy having been sold at the first point on the horizontal lines to the left, namely the issue date, that the valuation date time has already elapsed during which certain claims were incurred. At that point of the valuation, however, maybe all of the claims and seldom all of the claims have actually been paid.

Therefore, an insurance company must at that point maintain reserves for these unpaid claims which have already been incurred. This amount that's handled for unpaid claims and the unpaid claim reserve comes in effect out of the earned premiums between the issue date and the valuation date. Part of the earned premiums have already gone to pay the cash claims that have been settled. A part of the earned premium has already gone for purposes of expenses and profits. Then to arrive at the valuation date, representing the future is the unearned premium. The unearned premium reserve. Concepturally this is the type of reserving that's required for any type of insurance, life insurance, accident and health insurance, fire and casualty insurance. The dif-

ferences, however, between life insurance and accident and health can be demonstrated better with an additional chart which I would like for you if you would, Jim, to put it on. We might look at that 1957 treaty illustration.
[115] THE COURT: Excuse me, before you go to another chart, do I understand you to tell us that the quantity to the right marked unearned premium reserve has to do with reserving against the happening of the risks assumed, is that correct? Is that what these reserves are for?

THE WITNESS: Against the risks assumed or claims to be incurred in the future beyond the date of that valuation.

THE COURT: That's right, for occurrences that will come into being post valuation date.

THE WITNESS: That is correct, yes sir.

THE COURT: But it is a risk oriented fund.

THE WITNESS: That is correct.

THE COURT: All right.

MR. SCHWARZ: Your Honor, if they are going to move to another chart, would voir dire on this one be appropriate even though it's not an exhibit as such.

THE COURT: I don't know how much of this you are going to be going through.

MR. MASINTER: I think it would be difficult to interrupt his line of thought and I would just propose that we go through it and counsel can come back on cross examination to the same charts.

THE COURT: All right, why don't we do it that way?
[116] MR. MASINTER: If we might, for the purposes of the record, just ask the Clerk to identify this as illustration #1 and consecutively.

THE COURT: Why not just have your minuterization or whatever you call it. They're marked Plaintiff's 20.

THE REPORTER: 19.

THE COURT: I thought 19 was a 1963 insurance examiner's report.

MR. MASINTER: Give each one of them a separate number, Your Honor.

THE COURT: Yes, that will be fine.

MR. MASINTER: So this will be Plaintiff's 20.

THE WITNESS: Now, this chart on the screen was intended to illustrate more than just the question of the difference between the reserves for life and A and H, but we can start with that illustration, which is represented to the left of the dotted vertical line. The chief difference between a life insurance reserve and accident and health insurance reserve is that the life insurance reserves are held on a net basis or a mortality basis, they are usually called whereas the accident and health reserve is held on a gross basis and those two blocks or two columns on the chart to the left of the dotted line represent the—at the moment of issue the effect of the $1.00 premium. On the left the life [117] insurance and on the right, the accident and health insurance. At that moment of time that these policies are issued there is no past liability for claims incurred but unpaid because we've just this moment sold them, so we're only looking at future, the prospective reserve, that is the unearned premium reserve.

In a typical credit accident—credit life insurance during about the time in question in this trial it might have been expected that a mortality life insurance reserve would run somewhere between, depending on the average age of the insured, but generally speaking about between 40 cents and 45 cents for each dollar. Therefore, the mortality reserve as illustrated here is shown at the bottom to be 42½ cents. This is arbitrarily between 40 and 45, but approximately the level of mortality reserves at about that time. The balance of the dollar premium was available at the moment of issue for other purposes.

At the moment of issue, however, for a dollar of premium for accident and health the entire dollar was required as reserve, that is shown on the block on the right hand side and if you'll reflect back a moment to the previous chart, you remember that I said that that chart which has two components, the reserve for claims incurred but not paid, a small amount, and then a larger [118] amount for unearned premiums which represented

future claims to be incurred and I said that that represented concepturally any type of insurance and it does, except that we would have been looking at a figure the size of 42 and ½ cents to the right, or for the future for the life, if it had been a life insurance policy than we would have been looking to the right of the block of a dollar for accident and health coverage.

MR. MASINTER: Does that complete this illustration then?

THE WITNESS: Yes.

THE COURT: I must say I don't understand why the—from what he said, is it because of a difference in the nature of the A and H on the one hand and the life hazards on the other that are insured against that makes you say, well, you have to in the case of A and H have the whole sum—you must reserve on a gross basis in the first instance or why is it that you say this must be done?

THE WITNESS: The difference is one that's really been brought about through the evolution of these two different types of insurance in the United States. The life insurance coverages, of course, were developed by life insurance companies and they grew up under sets—different sets of regulations and different sets of [119] statutes and the requirements for reserves under life insurance policies were regulated different. Being, as it's always been since the first of the regulations measured on the basis of a mortality table and interest rate which became the so to speak net reserve or net premium reserve.

Accident and sickness insurance was introduced in this company not through the life insurance industry, but through the fire and casualty companies and the fire and casualty companies were from the very outset of their regulations required to establish gross unearned premium reserves because of the argument that in an event of termination or cancellation of these policies by the insured, before the term had expired, that the insured would be entitled to a refund of the net portion, that is the part for carrying the insurance risk but he'd also be

entitled to a refund for the loading portion or that amount available for commissions and other items.

Therefore, the arguments were that for soundness an insurance regulation has always been directed towards a solvency test versus a going concern or earnings test, so from the very outset, fire and casualities companies were required to establish reserves on a gross premium basis versus a net premium basis for life insurance companies.

Accident and sickness insurance policies which [120] were first brought into this country were of the same nature, namely that they were cancellable by the insured and the insured could cancel between the date of issue and the expiration of the period of coverage and so it was not unnatural for that type of coverage also to have a requirement of the gross unearned premium reserve versus the net unearned premium reserve.

THE COURT: So that when you're talking about life in contradistinction to A and H from the standpoint of the insured's ability to cancel, you're talking about credit life, is that it? You are not talking about life insurance generally, are you?

THE WITNESS: I was speaking generally up until this point, that is that in accident—in sickness insurance whether it were credit or individual policy, it has always been a requirement since requirements were established to put the reserves up on a gross basis.

Life insurance, on the other hand, has never been sold by casualty companies and even though credit life insurance—credit life insurance policies can be and are cancelled in the same manner as credit A and H, the credit life policy falls under the regulation which grew out of the life insurance industry.

THE COURT: So then your answer to the question that I put to you a few minutes ago is that the difference [121] as between generally gross in the A and H and net in the life instance of reserving is not attributable to any intrinsic or institutional difference in the risks insured against rather as just the product of regulatory history and the fortuity of a segment of the industry that originated the two types of coverage.

THE WITNESS: Yes sir, that is my opinion.

THE COURT: So that one other thing, you are not telling me that in the plaintiff's 20, that in your dollar, that you had up there, or is it Plaintiff's 21, I guess.

THE WITNESS: 21 yes.

THE COURT: The dollar that you had up there for A and H, you're not saying that it has no—within it, there is no counterpart to the 12 and ½ percent that you reflected in your life graph.

THE WITNESS: No, I'm not saying that at all, in fact to the left of the dotted line, those two columns were intended only to show the breakdown of reserve or how the reserves were established between the two lines.

THE COURT: How it in fact is done, not to attempt to give us an x-ray of the reserves or any blue print of their constituent element or makeup, is that it?

THE WITNESS: That's correct, and if we could refer to that exhibit 20 again, which he's put back on [122] THE COURT: 21, I misspoke. That's 21.

THE WITNESS: That is 21, referring to Exhibit 21, the right hand side of the chart to the right of the dotted line was added to show the reason why many, most of these small companies did in fact reinsure accident and sickness policies in a different fashion from life insurance policy and the reserve is a major consideration in that. Looking in the left side, we see for every dollar sold of life insurance, there was an immediate gain of 45 cents given the 42 and ½ cents is representative of the mortality reserve which for illustrative purposes is certainly within a reasonable figure, 12 and ½ cents in the case of these agreements that are in question, was at the outset the charge of American Bankers, the sum of which is 55 cents.

That then left 45 cents which was an immediate gain, so if 100 percent of the risk had been passed on to the small company Consumer by American Bankers who issued this dollar life policy, there would be no adverse affect on our small capitalization from the life insurance.

On the other hand, when American Bankers held the entire risk until it was earned on A and H, it established the dollar reserve and received the dollar premium as

time wore on and part of that premium was earned, it took the earned portion, from it it paid the [123] claims and gave the balance minus the 12 and ½ cents or 12 and ½ percent onto Consumer.

To the right of the dotted line is the effect that would have been on Consumers if they had not reinsured on the basis that they did, the A and H. For every dollar of premium insurance—premium sold, and they would have received them without the reinsurance, that dollar through American Bankers which had to issue the policy since they were the ones that were licensed, they would have gotten the dollar but they would have had to pay American Bankers 12 and ½ cents. Thus, creating an immediate loss of 12 and ½ cents for every dollar of A and H premium written and this was the effect it would have had on any and all small capitalized companies, companies with small capital and if I could proceed to the—these illustrations on the board in front of us or the screen in front of us, all from the initial agreement, the '57 agreement before the introduction of a Commission paid to the Consumer Finance agents.

But if we will look to the next chart, you can see how the situation was worsened without reinsurance of accident and sickness on the basis that they reinsured, how the connection worsened after adding commissions. On the left the '59 amendment reduced the immediate gain for life insurance to Consumer from the 45 cents down to [124] 28 cents due to a 20 cent commission but with a simultaneous decrease in the amount retained by American Bankers from 12 and ½ cents to 9 and ½ cents.

Now, there was no change in the effect on Consumers of the A and H even though there was an addition of a 20 percent commission because under the treaty the Consumers received their portion of that only as time wore on and they earn their portion of it. If though they had been without the reinsurance of accident and health or it had been reinsured on the same basis as the life to the right of the dotted line on this chart, we see that their loss has grown from 12 and ½ cents for every dollar sold to the sum of 9 and ½ cents plus 20 cents, 20 cents

now being the commission paid to the Southern Discount agent and a reduced charge to American Bankers of 9 and ½ cents.

Now, in the very beginning with Consumer's capital at $37,500.00, with say an arbitrary loan period selected to be six months for their average loan and assuming that a life insurance and an accident and sickness insurance policy was sold with every transaction, and based on the premium rates charged for the life and for the A and H at that period of time—

MR. SCHWARZ: I object to the assumptions regarding the length of the loans and the health and life insurance.

[125] THE COURT: Overruled. He's making these assumptions. These are not going to be considered by me as any evidence that these were in fact the case. He can assume anything he wants. Now, you're going to tell us how much they lost, is that it? Or would have lost? Or been in the hole?

THE WITNESS: Shall I go ahead?

THE COURT: Yes.

THE WITNESS: My purpose of course is to show that there was need to with limited capital to restrict the amount of accident and sickness insurance and I'm starting with six months because on six months, the relationship between the premiums and the reserves would have meant that there was a net loss on every sale which obviously this company or no other company could have endured. If we go to the average period of loan for that company at that time, which I am aware of which is in a range of 15 to 16 months, and take the same arithmetic, you will find that they will have been required to co-insure or reinsure 75 or slightly more percent of their business in order to have avoided this net loss on every transaction, so my point is only to illustrate not that they did in fact have a loss or just exactly what a breaking point was, but to make it—to present what in my belief is the truth that there was a decision or [126] consideration involved that there had to be a different treatment for accident and sickness than it did life and

this was true, not just for this company in my opinion, but many other companies that I have worked for.

THE COURT: Is this loss that you see of this potential loss based on these hypotheses that you've told us about, is that in any way related to the states capital requirements imposed on originating carriers, if you will, or whatever you call these people that deal with the insurance, write the—if not, what's the basis for this capital requirement just in general as you understand it?

THE WITNESS: The limited capital of 37,500, is that your question, sir?

THE COURT: No, weren't you in the Courtroom when Mr. Borne—that was the capital in fact and I understood it, that was one of the things that induced them to incorporate in Arizona, which is as I understand it, a sort of the insurance industry's Reno or Virgin Islands or something like that. All right, now he said that had they not been a reinsurer, had they functioned in Georgia, for example, as what I would call an originating carrier, that whether they were incorporated in Arizona or not, Georgia would have required them to have an invested capital of on the order, I think he said of $400,000.00 and my question is what's your understanding [127] as to why Georgia would have such a requirement or North Carolina or these other states that do require such a carrier to have relatively consequential capital investment, relative to for example Consumer's 37,500.

THE WITNESS: Well, in my own opinion and experience is that states, all of the states including Arizona now require a larger capitalization and they have—this is one of the areas in which the states are not very uniform but is one of the areas in which they all are uniform in concern about not having companies properly capitalized to go into the life insurance business so they have been continually increasing the capital requirements and Georgia's capital requirements are no longer 400,000 either. They are substantially more than that.

THE COURT: Fine, and what is it then, that causes this?

THE WITNESS: The motivation for increasing the capital requirements?

THE COURT: To cause the states to do so, yes.

THE WITNESS: It's to avoid the possibility that small companies through chance fluctuations and perhaps mismanagement and other reasons could become insolvent.

THE COURT: Would it be fair to say that it would have something to do with tending to insure the [128] integrity of the risk assumption that they're purporting to undertake.

THE WITNESS: I think that's fair to say that, yes sir.

THE COURT: All right, proceed.

BY MR. MASINTER: (Resuming)

Q What economic effect on the income and the capital or surplus would this type of loss ultimately have?

A Well, it would depend on the growth rate but if for instance some provision had not been made to keep the potential initial statutory loss—also appreciate that that loss was not real but it was real enough to make the company statutorially insolvent and had it grown faster than this capital would permit it to, namely suppose on every sale they lost 12 cents. It's just simply arithmetic to tell you how many dollars of sales that it would take to wipe out 12,500 of surplus.

Q Within a short period of time, a company that did this type of activity would become insolvent from a statutory point of view?

A Precisely and for these companies that went into this type of business following World War II, there—one of their strongest business incentives was to maintain a low capitalization because they were accustomed to earning a much better rate of return on their investments. Among [129] other things. But, they also were smart enough in my opinion, to recognize that they could get the insurance profits by establishing these companies and operating them as they did.

THE COURT: By letting someone else—

THE WITNESS: Put up the money.

THE COURT: Put up the money.

BY MR. MASINTER: (Resuming)

Q Now, I believe that you testified that the various states regulate requirements for reserves. Can you testify as to under what circumstances the states require reserves to be established and would you relate it please to life insurance, credit life insurance and accident and health insurance.

A Right, the statutes in almost all—well, in all states are uniform with respect to the reserve requirements for certain lines and types of insurance. Generally speaking, the catchall provisions cover the types of reserves that maybe you find on credit insurance. You don't specifically find on all cases rules or regulations or statutes regarding credit insurance reserves per se, but essentially all reserves are in effect a type of unearned premium. If you take an individual policy life insurance contract that says is payable—premiums are payable through the man's lifetime and the [130] face amount's payable on his death, the reserve at any point in time on that policy is in effect retrospectively defined as the accumulation of what he's paid in premiums in prior years that have not yet been used for purposes of payments of claims. This is on the net premium basis, so that is in a conceptural manner of speaking an unearned premium. The reserve requirements for all types of insurance given—if you agree with that point—is to establish the unearned premium for the right hand side of chart #20 with respect of events yet to happen and of course, if you already experienced claims and haven't actually paid them, you have the reserve element on the left hand side.

THE COURT: If you have experienced claims, but they're yet unpaid?

THE WITNESS: Yet unpaid. That's normally a very small fee, but added to that chart for completeness because at any moment of time you always have claims in process that you know about and they occurred before your valuation, they don't any longer come out of unearned premiums. They came out of earned premiums, but you haven't actually made the disbursement.

THE COURT: On the reserving in the case of A and H I meant to ask you this earlier, when you were contrasting it with life, you do or don't mean to tell us [131] that the likelihood of occurrence of the risk of the covered risk in A and H is not susceptible to actuarial forecasts.

THE WITNESS: No, I do not mean to tell you that.

THE COURT: So that's not the reason again why there's this gross reserving that you spoke about. That the art simply won't let anyone actuarially predict or guess what the chances of loss occurrence are.

THE WITNESS: That's quite right.

THE COURT: Proceed.

BY MR. MASINTER: (Resuming)

Q Did we define to your satisfaction what is meant by unearned premium and could we just review that again?

THE COURT: I wish you would because I don't still understand it.

BY MR. MASINTER: (Resuming)

Q Let's see if we could—

A The unearned premium and consequently the unearned premium reserve is that amount of the premium which has been paid and not yet been exposed to the risk insured against, and referring again to chart 20, at the point of valuation supposing that we have received a dollar for a one year coverage at the point of valuation, let's suppose that's the mid-point of the year. At that [132] point 50 cents of our dollar has been earned out of which we have paid claims. We have to set aside still some part of it for those claims that were incurred in the first six months, but we haven't actually made the disbursement.

The unearned part of that dollar is the 50 cents which represents the period to be covered in the future beyond the date of valuation and that is also the unearned premium reserve. If it is on a gross basis. If it's on a net

basis it would be that 50 cents for the future minus loading or another way of defining it would be the 50 cents minus the mortality reserve would be released as profit.

Q What then do we mean by an earned premium?

A Well, the earned premium is that part of the premium that has already been exposed to and suffered the burden of claims incurred from the date of sale to the date of valuation.

Q How does it become earned?

A By the passage of time and exposure risks being expired.

Q So that if no claim is made as each month passes, you earn one month's worth of premium is that correct?

A That's over simplification in the credit, but conceptually there's no reason not to agree with that. [133] And I think in terms of a level coverage or over a 12 months period with the coverage in each month being the same as the prior month, as each month passes, 1/12th would be released as earned and if you had no claims, of course, you would have all gain for that month.

Q I think this might be an appropriate point then for you to summarize if you would the accounting, actuarial and financial reasons for reinsurance.

A Well, the reasons for reinsurance or co-insurance which I use more or less interchangeably are numerous. One of them of course is certainly to spread the fluctuation and claims in experience. Quite frequently people speak of reinsurance as some sort of a cure for—or a permanent solution or protection against claims and of course, anyone who is experienced in reinsurance is going to be and I know all the writers on this subject agree, that reinsurance in effect is a vehicle whereby you can spread out fluctuations and to illustrate that point and this is for the risk element, so-called risk element of reinsurance and to illustrate that point, this chart on the screen now, in say a typical situation of a let's suppose a credit life insurance policy we anticipate on the average our loss ratio to be 42 and ½ cents.

Q Excuse me, may I interrupt you so we can identify this chart?

[134] MR. LANDON: This is Plaintiff's Exhibit 23.

A Now, if we wanted simply to reinsure so as to guard against having to pay more than 42 and ½ cents out by a large sum during any one period, then which we might expect in practice because in the right hand side of the chart you see columns which fluctuate in height. Well, this is in fact what happens in insurance business. Our averages are good. First of all, only if we have large numbers but also for long period of time. So reinsurance is frequently to have someone else absorb those high red boxes which in practice occur due to fluctuations, chance fluctuations or any other types of fluctuations, epidemics or catastrophes or what have you and for which though we pay a premium.

Our premium reinsurance is going to in the long run pay the claims of reinsurance plus a profit, so reinsurance to spread the risk is one of the most frequent uses of reinsurance.

The very common use for reinsurance is to help in the capital requirements of companies and many times you find companies which otherwise have large and substantial capital accounts still will reinsure on a co-insurance basis which is really a subject substantially more complex than the question of reinsurance and reinsurance for capital purposes in this case, but they do it in order to [135] keep their statutory earnings from fluctuating violently and they will use the same approach, that is to have someone else put up the money for them, the liability for them as is the case with the reinsurance of the accident and sickness insurance here. That is American Bankers putting up in effect the liability and in releasing earnings to Consumer. I am speaking now of course of the '57 contract, on an earned premium basis.

So there you have the capital reasons for reinsurance and co-insurance.

THE COURT: I guess we could assume that Equity Funding reinsured for capital purposes.

THE WITNESS: Precisely. An interesting sidenote to that, policyholders are the only ones that are going to be protected in this thing. At any rate—

THE COURT: But you didn't mean that much capital benefit?

THE WITNESS: No, not in that way, either. The other ways for reinsurance are to use the services or facilities of the reinsurer or even the case that we have here in the '57 agreement, this is using the facilities—the reinsurer was using the facilities and services of the insurer, the ceding company, American Bankers. The—every insurance product has several elements and—has—in determining premiums. You have the risk itself. The [136] mortality or morbidity expectation. You have an investment element and that is whether you will be able to earn the amount of interest on the reserves or the funds as you build them up in accordance with your expectations. You have the expense element, whether or not you can generate a sufficient volume of business yourself to pay for the overhead expenses that are necessary to be in a business at all. You have the question or the element of persistency, whether the business will lapse too rapidly or not, and you find insurance companies reinsuring with one another and coinsuring with one another for any and all of these reasons.

THE COURT: Does the principle of persistency apply to casualty insurance?

THE WITNESS: It does to a lesser extent, but it certainly does, yes sir.

BY MR. MASINTER: (Resuming)

Q How then does reinsurance affect the requirement to maintain reserves?

A Well, if you would think in terms of the reserve being a liability offsetting your asset which was generated from a premium—

Q Let's stop there, you mean if I pay a dollar premium, you said generated from a premium then that becomes an asset?

[137] A That's right.

Q To the company?

A Right.

Q What then is the liability?

A Well, offsetting that must be your reserve requirements or your unearned portion of that premium. If it's life insurance, it's a mortality net unearned item and if it's accident and sickness insurance simply because of the way the regulations evolve, it is the gross unearned portion of it, but with reinsurance contracts regardless of how complicated they get and there are some very complicated arrangements, the easiest way to establish who has to reserve is to determine where the premium falls, and who finally holds the asset and that is essentially the way the reserves are established, the requirement for the reserevs.

Q How is that—

A Sir.

Q How is that reflected on insurance companies balance sheet or reporting requirements and things of that nature?

MR. SCHWARZ: Your Honor, that question goes to state unearned premium reserve requirements which are maintained by insurance commissioners and it seems to me this is the kind of thing which Mr. Eddy is not [138] qualified to testify to.

THE COURT: I think he can express his understanding. His understanding in this connection, as I get it aligns with Mr. Borne's who told us that he thought that reserve requirements followed possession of premium revenue and was thus determined rather than risk assumption. He didn't think risk assumption had much to do with it, but you just looked for a given premium dollar and find out who's holding how much of it and his understanding would be that that any reserving requirements ought to be done in those proportions and as I understand this witness he goes along with that, he's telling us the same thing, I think, so again that isn't going to be taken to show that that's Arizona law or Georgia law or any other kind of law as far as I'm concerned. That's his impression, that's his observation and he's free to give us that. Proceed.

THE WITNESS: There's a chart and I don't know the number of it that might show this better and I—

This chart was built on the basis of—

MR. MASINTER: Excuse me, can we identify this chart?

THE REPORTER: I think it's #24.

MR. MASINTER: #24, entitled Initial Effect of 1957.

[139] A This chart assumes that the life insurance reserves or mortality reserves were 42 and ½ cents per dollar of premium which was an arbitrary assumption on my part but still in my opinion it's about in the range it would have been.

In the 1957 agreement, American Bankers was the company dealing with the insured and that's shown here on top and the flow of money or premium came from the insured to American Bankers through the American Bankers to Consumer Life. With the flow of life insurance premiums the American—on the left, American Bankers withheld their 12 and ½ cents which was available for their expenses and profits and remitted 87 and ½ cents to Consumer, who had to establish the life insurance reserve, here assumed to be 42 and ½ cents given immediate effect of 45 cents gain for the life insurance reinsurance.

The accident and health reserves and reinsurance program is demonstrated on the right. A dollar flowed to American Bankers from the uninsured, they retain the dollar and establish the reserve. Now, they have an initial loss on this if they allocated their expenses to the various—to the expenses of this life, but they pass nothing on in the way of money or reserve requirements to Consumers, so at the outset this reinsurance [140] reserve to Consumer was zero and their gain and loss, the effect on their surplus was zero and if you'd like to put the '62 chart up.

THE COURT: Well, excuse me, before you take that one down. Go ahead, Mr. Masinter.

MR. MASINTER: I was going to continue just so we could establish in this line of testimony how this type of thing is reported. In other words, the type of reporting requirements that American Bankers for example would be required to make and how it would show

the effect of reinsurance on its statements that it's filed.

THE WITNESS: Right. In the annual report of American Bankers for the life insurance under this agreement, they would have indicated in Exhibit 8, their life insurance policy reserve exhibit a gross reserve requirement here of 42 and ½ cents. They would have shown however, an offset in deduction on account of reinsurance ceded to Consumer of a reserve credit equal to 42 and ½ cents. Therefore, at a net reserve on American Bankers' books, was zero. The reserves on the books of Consumers was the 42 and ½ cents. The A and H reserve transaction would have been in Exhibit 9 of American Bankers statements they would have shown a dollar reserve gross of zero credit for reinsurance and therefore, a net reserve requirement of a dollar, and Consumer would [141] have shown zero reserve requirement on its books.

BY MR. MASINTER: (Resuming)

Q Now, these reports would be filed with the various states, is that correct?

A That's correct, American Bankers would have filed theirs with the states in which it was licensed and also with its home state, Florida and Consumer would have done the same with its home state of Arizona.

Q In your experience do you participate in the preparation of these annual reports?

A Yes sir, I do.

Q Are they examined—you mentioned before about some sort of zone examination procedure. Is this the report that they would examine?

A They examine this amongst other things, yes.

Q Now, if there were some fallacy with this method of reporting, would it normally be challenged by those examining the reports?

A Yes, in my opinion the examiners of either of these companies if they'd considered these reserves inappropriate they would have commented on it. And shown the—

Q How would that have been raised?

A How would that have been raised?

[142] Q You say they would have commented. How would the comment have come about?

A Well, as a result of each examination and generally tri-annual examinations, the examiners under the leadership of the chief examiner write up their findings in a report and the report of the examination itself in which they either confirm or differ with the various items of assets and liabilities reported by the company in its statements.

Q And presumably if they confirm and do not challenge the method of reserve treatment, then one would presume that the method of reporting is acceptable and in accordance with state regulatory law and regulations?

A That would be my presumption, yes sir.

THE COURT: Are you going to move on now, Mr. Masinter. Are you going to move away from Plaintiff's 24?

MR. MASINTER: I was going to come back to it, but go ahead, Your Honor, if you have a question.

THE COURT: Well, I just wanted to ask the witness if you were going on to something else, Plaintiff's 24 captioned Initial Effect of 1957 Agreement, I take it this is something you prepared or was prepared under your auspices or direction?

THE WITNESS: Yes.

[143] THE COURT: All right, tell me then presumably you're familiar with the 1957 agreement that you purport to portray with this chart. With regard to the A and H, what is your understanding as to the incidence of the insurance risk as between American Bankers and Consumer Life. Does Consumer Life under this agreement agree to reinsure the entire risk assumed by American Banker from its policyholder?

THE WITNESS: Yes sir, on an earned premium basis.

THE COURT: Now, wait a minute, what do you mean on an—does it agree to—forgetting about the earned premium or anything else does it with no strings attached, as it were, and without limitation tell American Bankers we will reimburse you for all loss claims under the subject coverage.

THE WITNESS: No sir, I don't think that it says that.

THE COURT: Then how is it limited?

THE WITNESS: It's limited by any amounts of premiums that it has or will earn under the contract during its effective period.

THE COURT: So it would be then what you might call a qualified or limited reinsurance from the standpoint of risk. They're only going to reinsure risks up to some [144] ceiling cutoff amount.

THE WITNESS: Yes sir, there is a ceiling in it.

THE COURT: Being determined by premiums received.

THE WITNESS: Being determined by earned premiums received. Earned premiums received or to be received.

THE COURT: How can you have an earned premium to be received?

THE WITNESS: Well, if my interpretation of the contract is correct, I'm only looking at it as an actuary of course, had say a month or two transpired in which there were no claims an earned premium had been passed on to Consumer, but a subsequent month there would have been a loss, then I do believe that this agreement would have required Consumer to pay back to American Bankers an amount up to the amount it had received from them earlier in the form of earned premiums, and also of course, they would be obligated to take no earnings in the future until that loss was wiped out.

THE COURT: Let me see if you can make it simple for me. Are you telling me that your understanding of the 1957 agreement is that in respect to a risk, a policy risk under which Consumer Life will receive $100.00 [145] that your understanding of this contract is that its liability to American Bankers on its reinsurance undertaking is subject to a $100.00 ceiling.

THE WITNESS: Yes sir, for the accident and sickness of course.

THE COURT: Proceed.

THE WITNESS: The next chart shows the same sort of flow in the 1962 agreements.

MR. MASINTER: Now let me stop you before you proceed to the 1962 agreement. I have a few more questions I want to ask specifically with the '57 agreement and then we'll move on to the '62 agreement.

MR. LANDON: Do you need this chart? '57.

MR. MASINTER: I think not.

BY MR. MASINTER: (Resuming)

Q Mr. Eddy, I hand you what has been marked or identified as Plaintiff's Exhibits 2, 3, 4, 5 and 6. Would you please tell us if you are familiar with each of those exhibits?

MR. GROSSMAN: Your Honor, if Plaintiff has made copies of those exhibits which were just marked for identification that were shown on the chart, we'd like to have copies.

MR. LANDON: Fine, I have them.

MR. SCHWARZ: Can we have them now?

[146] MR. LANDON: Let me mark them.

BY MR. MASINTER: (Resuming)

Q Now, Mr. Eddy, I show you what has been identified as Plaintiff's Exhibit #9, which is identified as Annual Statements of Consumer Life Insurance Company for each of the years '57 through '64 and I ask you to—

And Mr. Eddy would you please state as to whether or not you are personally familiar with each of the exhibits identified as Plaintiff's Exhibit 2 through 6 and Plaintiff's Exhibit #9.

A Yes, I believe they to be the reinsurance agreements and the annual statements which I have read.

Q Now, Mr. Eddy, for ease of reference and in your testimony, I am going to find these reinsurance agreements in two separate periods. The period commencing in 1957 until 1962 we'll call period one and treaty one, and the period beginning in 1962, we'll call period two and treaty two. And the writing company or the originating company you call the ceding company, the one who does the reinsurance, you can call the reinsurer, so if we can keep those terms consistent, I think it would help with future questions.

Now, I would like for you to refer specifically to treaty one and describe a specific way, the method in [147] which this reinsurance was handled, both life insurance and the accident and health insurance and if you want to, you can go back to using the chart. I think some of this you have already done, but I would like for you to describe specifically the method in which this insurance was insured and reinsured.

A I do believe that the chart that was last on the screen shows how the reinsurance did operate between American Bankers and Consumers in the '57 agreement and the premiums were collected by Consumer Finance offices remitted to American Bankers where these transactions took place. The monthly accounting—I believe it's monthly accounting in the '57 agreement determined the amounts of earned premiums accident and sickness during the period during the month of accounting and also determined the amount of the 12 and ½ cents earned on that earned premium, also determined the amount of claims that were paid and the increase in claim reserves for claims incurred during that period but still unpaid at the end of the period, the net balance being paid to Consumer.

On the life insurance part 87 and ½ cents was paid to Consumer as the premiums came to American Bankers. Again, I believe on a monthly accounting basis.

Q Now, what is the method by which these premiums [148] were remitted from the ceding company to the reinsurer? Under this agreement, in treaty one.

A You mean monthly for example and on 85 cents, 87 and ½ percent rather, 87 and ½ cents on the life policies and on an earned premium basis on the accident and health.

Q Earned premium, and that would be earned over the period of time specifically monthly, is that correct?

A Earned during the accounting period.

Q Earned during the accounting period. Is this method of remitting premiums on an earned basis for an accounting period common in the insurance industry?

A It was certainly common in the credit insurance industry, yes.

Q So then would you say that it would be usual or unusual to remit premiums on an earned basis for an accounting period in a situation where the originator of the insurance or the direct writer of the insurance received a single premium?

A It is common to do that. That isn't restricted to credit insurance, of course. That's common practice in other types of insurance too.

Q Such as?

A Well, life insurance. They are a lot of [149] reinsurers of life insurance policies who will accept premiums on a monthly basis which is in effect on an earned basis, whereas the issuing company, the ceding company, may charge premiums on a quarterly basis or a monthly basis or an annual basis or for that matter, a single premium basis.

Q Now, Mr. Eddy, you have examined the treaties and the annual reports for period one, would you please describe how the reserves for life insurance and accident and health insurance were dealt with in treaty one and also how they were dealt with in the annual reports themselves for the years during period one?

A I belive I'll be repeating myself, Mr. Masinter, but they were handled during period one as demonstrated on the board and they were handled in the annual statements that way. That is, on the statements of American Bankers they showed the gross reserve for life, 42 and ½ cents or whatever figure they used for the actual life insurance reserve. 42 and ½ cents is simply an illustration and they showed a net credit for the same amount which they had taken as being held by the reinsurer. In this case, the Consumer Life. Consumer Life held 45 cents as its reserve—I mean 42 and ½ cents as its reserve on its own annual statement as being the accepting company or the reinsurer. The accident and sickness insurance, American [150] Bankers held a dollar gross, no credit for reinsurance. Consumer Life showed no reserves on this statement.

Q Now, in your opinion as an actuary and as an accountant, was this treatment of the reserves in the annual reports correct?

A In my opinion, it's strictly in accordance with the 1957 agreement and the only way that it should have been handled in accordance with those terms.

Q Would it have been improper in your view for American Bankers not to have reported the reserves with respect to the accident and health insurance, but for Consumer Life Insurance to have reported the reserves.

A Well, my opinion, because of the terminology of the treaty that if American Bankers had not held their reserves, they would have been required to have held them upon examination.

THE COURT: I don't quite—tell me this again. Assuming that in the A and H area Consumers liability as a reinsurer was limited to the amount of the premiums that it received, you did acknowledge I think that by this you didn't mean that if it was going to receive premiums monthly that it's responsibility would be limited to that which it received in the particular month of the loss under the coverage, but rather that it would be responsible to the extent that it had previously received [151] premiums under that coverage as to which it had not been required to respond with any loss reimbursements, didn't you?

THE WITNESS: Yes, I did.

THE COURT: All right, now as a matter of reporting practice in accounting practice, it's your view that there would be no reserve requirement devolving on Consumers with respect to the amounts of premium dollars that it had received and accumulated, if you will, under an existing coverage. That being a part of the nest egg that was supposed to be on hand for it to respond to American Bankers in the event of a loss claim.

THE WITNESS: No sir, it would not have and if you go back to the Exhibit 20 and remember that on the left hand side of our chart on 20, we had some reserves but they were just for unpaid claims that had already been incurred.

THE COURT: No, please, now you're going to confuse me. I don't want to go back to 20. I just want to know—

THE WITNESS: I'll try to respond in different words then, but once the premium is earned and you have paid the claims that were incurred of that period of time that those premiums were earned or set up reserves for unpaid claims.

[152] THE COURT: All right.

THE WITNESS: The rest goes to profits or surplus. It is not an earmarked fund any longer.

THE COURT: Excuse me, didn't you just say here a minute or two ago that the reinsurer would be required to apply those earlier earned premiums that had not been exhausted by claim reimbursement to the satisfaction of a future claim on the coverage in question. Didn't you say that?

THE WITNESS: Well, I said that, but that is not one of the required reserves of a life insurance company. No more is it that they were required to pay losses on the life insurance policies in the future more than the premium income. Had that happened, they would have to have called on their surplus accounts to pay them.

MR. SCHWARZ: Your Honor, I think this is an appropriate time to correct what I think is an erroneous assumption on which you've been asking your questions and that's the term of the treaty relating to these loss payments.

THE COURT: Well, you can go into that on cross. Proceed, Mr. Masinter.

BY MR. MASINTER: (Resuming)

Q Mr. Eddy, I show you what's been identified as Plaintiff's Exhibit #10 and 11 which purport to be [153] reports of examination by the insurance department of Arizona for Consumer Life Insurance Company as of April 30, 1969 and as of December 31, 1963, and I ask you are you familiar with each of these reports.

A Yes sir.

Q Do those reports confirm with your—confirm your opinion as to the correctness of the treatment of the reserves? As between American Bankers and Consumers?

A Yes sir, inasmuch as they agree with the reserves that the company showed on its statement. I take it to be—

Q They didn't challenge in any way the reporting of these reserves by American Bankers—

A No, not in these reports, no sir.

Q Thank you, now I would like to turn your attention to what we have called treaty two, which you have in front of you for the second period of time beginning in 1962 or period two. Now, with respect to these treaties, would you please describe the method by which the insurance was reinsured in the case of the life insurance and the case of the accident and health insurance.

A If I may look at the next chart.

MR. LANDON: For the Clerk's identification Plaintiff's Exhibit 25, chart entitled Initial Effect [154] of 1962 Agreement.

THE REPORTER: 26.

THE COURT: Should be 25, I believe.

THE REPORTER: I'm sorry, 25.

THE COURT: I think at the close of the case counsel might want to chip in to buy the reporter an abacus to keep track of these exhibit numbers.

THE WITNESS: The 1962 agreement reversed the roles of Consumer and American Bankers inasmuch as Consumer then became the issuing company and they issued the policies to the Southern Discount debtors and they became the ceding company and American Bankers became the reinsurer. There were no reinsurance of life in the '62 agreement as there was no need for any assistance from American Bankers or anyone as far as the capital problem was concerned on the life insurance.

The accident and sickness insurance was coinsured 80 percent in the initial contract with American Bankers, which in effect and oversimplified simply meant that American Bankers took 80 percent of each risk and Consumers took 20 percent of each risk as if they were both each selling a policy to the prospective insured. They way it worked was that a dollar was collected, a 50 cent commission was paid out to the finance company, then a gross transaction of 80 cents was passed on to American [155] Bankers. They—

MR. SCHWARZ: Would you repeat that answer. What was paid as commissions?

(Answer played back.)

A The gross premium was transmitted to American Bankers in the amount of 80 cents. They theoretically or likewise had a gross remittance to American—to Consumer equal to 40 cents representing commission of 50 percent on the 80 cent premium.

Now, the effect on the books of the two companies were to show a loss in the case of Consumer of 10 cents and a loss in the case of American Bankers of 40 cents. That simply arrived at was the gross premium minus commission, minus reserve, since the gross premium was a dollar, commissions were 50 cents and the reserves were a dollar, there was a total loss of about 50 cents, 20 percent of which was borne by Consumer and 20 percent of 50 being 10 cents and 80 percent borne by American Bankers or 80 percent of 50 being 40 cents.

Q Would you tell us, Mr. Eddy, the method by which the premiums were remitted under this treaty two.

A I think quite similar to the '57 agreement except I believe that the accounting period was quarterly rather than monthly.

Q Is there anything unusual about this treaty [156] two or would you say it was common in the industry?

A Yeah, I think it's very common. Reinsurance agreement on a quota share type arrangement and it was very common with the credit insurance operation. Now, there was another feature of this treaty not demonstrated in this chart and that was that there was a provision for an experience refund, the form of which itself was very common in the reinsurance treaties of all sorts, not just credit reinsurance treaties.

Q Briefly, how did that operate?

A In effect, allowed that if the claims were in fact less than the premium, net premium which American Bankers had received which in the case of their portion of a dollar original premium, they actually received 40 cents. Had claims been less than 40 cents minus a charge made by American Bankers for their function in this operation of three cents or namely if claims had been less than 37 cents, then there was an experience refund form of which provided that any savings or any claims or any excess of this net premium minus the claims minus the three cents would be refunded to Consumer as an experience refund.

Q Would you say that that provision was common in the industry during this period of time?
[157] A Absolutely.

Q Now, Mr. Eddy, based on your examination of the annual reports of Consumer Life Insurance Company for this period two, would you please describe the treatment of the reserves as reflected on those annual reports?

A On Consumers reports?

Q Consumers reports, yes.

A Consumers showed the gross reserve of a dollar in its Exhibit 9, took credit for 80 cents and showed a net reserve in Exhibit 9 of 20 cents.

Q That's on the A and H?

A That's accident and sickness I'm speaking of. They put the entire reserve for life insurance on their statement on gross amount, took no reserve credit for reinsurance because there was none.

Q In your opinion was this treatment of the reserves correct from an actuarial and accounting point of view?

A Yes sir, in accordance with agreements.

Q Now, also you have examined the report of examination by the State of Arizona for Consumer Life Insurance Company. Does this report confirm your opinion as to treatment?

A That report for 1963 does in fact state that it accepts the reserves as they were shown on the statement.
[158] THE COURT: The Reporter has to make a pit stop so we'll recess for ten minutes.

(Whereupon, a brief recess was held.)

THE COURT: Is counsel ready?
MR. MASINTER: Yes, Your Honor.
THE COURT: Proceed.

BY MR. MASINTER: (Resuming)

Q Mr. Eddy, turning now from the specific agreement back to a general discussion of reserves, I would like for you to state again the best of your ability and I know it's going to be redundant to a certain extent, but

would you please state in your opinion the method by which an actuary would determine which company that maintained the reserve.

A Well, essentially the reserve would follow the premiums. Whichever company held the premiums, generally speaking held the reserve.

Q Would the actuary look to see which company assumes the risk under the reinsurance agreement?

A Well, generally speaking too that the premiums will be some relationship in the contract between the premiums and the risk. Now, the premium payment method or mode might be different from say a single premium, whereas this is a single premium contract, as is the case here, but they are not totally independent considerations. [159] But you will look at both of them of course.

Q But the general rule would be that the reserves would follow the premium dollars?

A Precisely. The reserves are really an earmark in the last sense and without having received the premium to create an asset, there's nothing to earmark and generally speaking there isn't any situation whereby reserves are created just without the receipt of premiums. There are some timing situations in the regular insurance business where you could argue that you have some lapse of time, a week or two between the date you receive a premium maybe, and the time you establish a reserve, but you'd still take credit for the premium as an asset as if you had received it in a situation like that, but essentially your reserves are established or an earmarked amount of assets.

Q In your experience, do you know of any situation or are you personally familiar with any situation in which an insurance company would be required to maintain a reserve under circumstances where it does not hold the premium?

A Not other than what I just alluded to. I mean just a possibility of timing problem, but even in that case you would set up an asset for premium due you, so that I can't say that I don't know of any situations [160] where that's actually the case.

THE COURT: Was it implicit then in what you're telling us that the gross risks, of which all reserves consist and are made, is the premium dollar?

THE WITNESS: Yes sir.

THE COURT: All right now if that's the case, then why—what is it that accounts for these states insisting on these invested capital requirements and conditions and minima.

THE WITNESS: Well, the capital and surplus accounts of the companies are over and above reserves, but reserves themselves are for individual policies and they are generated out of assets created from premium income.

THE COURT: So the distinction between the two is that a reserve by definition is a contingency fund in the nature of a sinking fund for a particular risk or a particular policy whereas general financial condition is exacted or required by these state capital requirements, has to do with just the general integrity of the insurer.

THE WITNESS: Precisely, and actually this general requirement you're speaking of is just to insure that companies have by statutory definitions an excess of assets over reserves and statutory capital and surplus [161] are assets over and above the assets needed to match reserves.

THE COURT: Well, when you tell us that the possession of the premium is the indicator that fixes the incidence of reserve, are you assuming that that premium will fall where the risk is so that really you're just in talking about the premium as the indicator, it's just another form of saying the same thing. Are you telling us that?

THE WITNESS: Yes. I think I can answer your question yes. The premium will follow the risk on some basis. I mean, it may go to the company paying the claim on a monthly basis or on a single premium basis but eventually the premium is going to land in possession of some company and while there is any premium yet unearned it has—there has to be established an unearned premium reserve offsetting that asset for the premium that's held that hasn't yet been earned.

But whoever has that premium is the one that has to have the reserve. Now—

THE COURT: And you think is also the one who has the risk?

THE WITNESS: To the extent of that much premium. As an example, if I might to illustrate this with an individual policy, life insurance contract, the [162] ABC Life Insurance Company will sign a contract with an individual promising to pay $1000.00 of death benefits if that individual should die, whenever he should die, which is certainly going to happen, but that individual can choose and does frequently choose to pay for this coverage on a monthly basis. The first month he might pay a dollar and say a fellow 25 years old might pay a dollar for which the insurance company is only risked for a thousand, but obviously it cannot put a reserve up for a thousand or we wouldn't have insurance companies.

It puts up a dollar and when it gets the second dollar, it puts up another dollar or what's left out of the dollars and so forth, and the same is true with insurance contracts between insurance companies. If the ceding company has an agreement that the reinsurer is going to take 100 percent of the risk, but does not pass 100 percent of the premium, for the same reasons that the situation I just explained couldn't happen, neither could the reinsurer put up 100 percent of reserve because it doesn't yet have the assets with which to do it.

Now, the reinsurer wouldn't enter into an arrangement—a knowledgeable reinsurer wouldn't enter into an arrangement whereby they would be compelled to put up the reserve without receiving the money and I [163] suppose there are situations and other reasons and conditions that might persuade someone to do that on a limited basis, but generally speaking that won't prevail.

THE COURT: Aren't there insureds in our case, Mr. Masinter, prepaying these premiums whether in life or A and H?

MR. MASINTER: Yes, sir, they're single premiums.

THE COURT: In all instances?

MR. MASINTER: Yes sir.

THE COURT: So you do understand that?

THE WITNESS: Yes sir, of course.

THE COURT: Well, then what do you mean they don't have—why in such an instance if the gross premium is paid fully in advance, what's the limitation that prevents apportioning the reserves in strict accordance with risk? I don't see the analogy of the fellow that's buying the term life and paying a dollar for $1000.00 coverage.

THE WITNESS: Well, I will give you an analogy that I think that might follow without any trouble. You have the situation in individual policies where an indivdual will buy a single premium life insurance policy and pay to the ABC Life Insurance Company $700.00 for that. The ABC Life Insurance Company reinsures it or [164] some portion of it, but it will reinsure on a monthly premium basis and even though it may reinsure 100 percent of the risk to the reinsurer as long as it's only remitting that premium monthly, the initial company, ABC holds the reserve to the extent that it has not released premiums to the reinsurer. And the reinsurer holds reserves only to the extent that it has received premiums from the ceding company.

THE COURT: Right, but it's doing that by choice. I thought you—

THE WITNESS: Doing it by agreement.

THE COURT: All right, but I thought your proposition here was, well, of course, they have to—the risk assumption can't be fully reflected with reserve maintenance because there haven't been enough dollars taken in to set up the reserves. I thought that's what you were talking about. That's why you had situations where people were assuming risks disproportionate with their reserves.

THE WITNESS: I was trying to make the point that the reserves are really an earmarking of the assets and whoever holds the assets should hold the reserve.

THE COURT: Proceed.

BY MR. MASINTER:

Q Mr. Eddy, is it correct or incorrect to say [165] that it is the purpose of reinsurance to shift the exposure.

A Well, as I tried to illustrate with one of the charts earlier the shifting of exposure in reinsurance is really to spread out fluctuations in exposure or fluctuations in claims. No one that buys reinsurance. No one that sells reinsurance expect not to have to pay for it or expect to gain from it respectively and that simply means that they are willing to take the burden of the fluctuations and spread them out for the ceding company. But reinsurance is referred to as reinsuring the risk but that's the net effect of it and that's the way that people who understand it look at it.

Q Spreading?

A Yeah.

Q Is that the same as a deferment of the risk.

A Certainly to the extent and of course this experience refund formula that was mentioned earlier, it's very common in standard reinsurance contracts for that very purpose if the reinsurer has a wide fluctuation and pays a lot of the red block in the first year, it's going to carry that loss forward until it has a chance to recover from future premiums, at least to the extent of the contractual agreement between the parties. American Bankers said that their later contracts allowed for [166] forgiveness of this carry forward after a certain period of time. Well, that forgiveness feature is in most contracts today. It wasn't ten years ago but it is today and competitive pressures have caused that to come out.

THE COURT: From your experience with observing the regulatory agencies, do you with respect to reserves maintained by insurers, whether they be ceding carriers or reinsurers, in the context of reserve adequacy, let us say, with respect to a particular insurance risk, its your impression that the regulatory authorities discriminate as between the four reserve purposes as between the ceding carrier and the reinsurer, or do they tend to view the two as a unitary matter and concern them-

selves only with determination that for the risk, the gross risk, that is to say the risk of the policyholder that has been insured by the two of them according to whatever arrangements they wanted to make inter se, is sufficiently reserve.

THE WITNESS: I believe, Your Honor, that invariably the terms of the contract or the reinsurance agreement prevail. They are certainly concerned foremost that adequate reserves are established, but who establishes the reserves? Assuming both companies are acceptable to the authority, which one is a possibility in some cases that's not true, but assuming both parties are acceptable, then they are concerned with the total reserve [167] is held, and that it's held in accordance with the agreement.

As an example the terms of this agreement with American Bankers, the 1957 agreement in my opinion the authorities would not tolerate Consumer holding that reserve on A and H without a change in contract. They would certainly I believe have agreed to a different contract where the reserve would be passed on to it on a single premium basis, but they would be bound by the terms of the contract.

THE COURT: And this is because your interpretation of the contract is that it limits Consumers loss liability to what you've described as the amount of its earned premiums, so that it shouldn't have any more in reserve than what you call earned premiums.

THE WITNESS: I don't think it is because they are limited although the limitations do have certain implications.

THE COURT: Well, you told me—

THE WITNESS: It's not because of that that they do.

THE COURT: All right, why does the contract say that under the '57 arrangement Consumer should maintain no A and H reserve.

THE WITNESS: Because mathematically the [168] understanding of reserves on an earned premium basis means that under that contract the American Bankers held the unearned portion of the money, therefore, establishing the unearned reserve. There are no such reserves as earned premium reserves. The only reserves after a

premium is earned would be unpaid claims and contingency reserves which are really just surplus amounts.

THE COURT: Proceed, Mr. Masinter.

MR. LANDON: We'll identify this chart as Plaintiff's Exhibit 26.

MR. MASINTER: (Resuming)

Q This has been marked as Plaintiff's Exhibit 26. Would you please explain this chart, Mr. Eddy?

A All right, this is another general business reason for considering a different arrangement for accident and sickness insurance, reinsurance, than that used for life insurance, with respect that the small limited capital companies in Georgia particularly in the past, considerable attention has been paid with respect to the small companies as to the volume of premium income and new premiums written to the company's surplus account, capital and surplus account, if you would in the stock company. Now, this simply illustrates that without reinsuring the accident and sickness that that [169] ratio of premiums written to surplus in any given company will be larger without that reinsurance than with it, and the smaller this ratio obviously the better financed or the better capitalized the individual company is with respect to the premiums that it has written.

Now, if the ratio is 10 zillion to one, obviously there's very little surplus related to the amount of premiums, and I don't propose to suggest what the ratio should be, simply in this illustration to show that the effect of the co-insurance in the '62 agreement, the 80 percent co-insurance, tended to keep that ratio of premiums to surplus at a minimum.

Or if you take the assumption that a company having a dollar of surplus at the outset writes a dollar each of life insurance and health insurance, then its ratio without the agreement on the left side of the chart, would be $2.00 of premiums written over the surplus which began as a dollar and under the '62 agreement, there would have been a 7 and ½ cent profit, and a 50 percent—excuse me, yes, a 50 percent reserve. A 50 percent loss on accident and sickness. I'll get it straight in a minute.

7 and ½ percent gain on the life and 50 percent loss on the accident and sickness, which would produce a ratio of roughly three and ½ to one but take the same company and let it reinsure [170] 80 percent of accident and sickness and its written premiums would be reduced by the 80 cents reinsured to $1.20. Its surplus would be the dollar which it began with, plus 7 and ½ cents earned on the life, less a 10 cents loss on the 20 percent of the A and H retained for a ratio of approximately 1 and a quarter to one. For small capital companies this is another argument and again all of this is due to the treatment of accident and sickness reserves which are required to be established on a gross basis rather than a net basis.

MR. MASINTER: I have no further questions. Your witness.

THE COURT: Cross?

(Pause)

CROSS EXAMINATION

BY MR. SCHWARZ:

Q Mr. Eddy, do you understand that under the general regulatory framework, the insurance commissioners have broad discretion as to whether to require a particular direct writer to maintain an earned premium reserve or take credit for that reserve under the reinsurance agreements which it sets up?

A I believe that in all jurisdictions that that is pretty well defined. The commission certainly [171] has in all states certain discretionary powers but as far as the establishment of reserves, I think that those are pretty well defined in all states.

Q Is a typical unearned premium reserve requirement—well, can you describe a typical statutory unearned premium requirement as you understand it?

A Well, first of all the standard valuation law will probably be the beginning.

Q Standard what?

A Standard valuation law which has been adopted by all the states and that will speak in specific terms of specific types of insurance and most generally the provisions—there is a provision which says in effect that other reserves not included herein or words to that effect are calculated on a—in a consistent manner and that would be supplemented in many cases by maybe specific regulations or rulings by—or directives from insurance departments saying that accident and sickness reserves will be held on gross unearned premium basis. Some states will say on a pro rata basis and some states will say by the rule of 78 and some states will be silent on this as to how and that's—

Q With respect to the initial reserve that a company is to set up, I believe you testified that all [172] states have a gross unearned premium reserve requirement, is that right?

A That's true for accident and sickness, yes.

Q And that's the kind of coverage we're talking about here?

A That's correct—well, we're talking about both I presume, but certainly accident and sickness also, yes.

Q Credit accident and health coverage you're talking is covered by your term accident and sickness, is that correct?

A All right, yes.

Q Now, other items you mentioned under pro rata and rule of 78, have to do with the manner in which the unearned premium shall be considered earned as time passes under the arrangement, is that right?

A That's true.

Q Now, in a situation where an insurance company reinsures accident and health business including the credit accident and health business involved here, are there statutory provisions generally permitting a direct writer to take credit for unearned premium reserves on reinsured business?

A I believe that would yes. The answer to that would be yes. Be the statutory or regulations.

[173] Q And where there's a statutory provision as you understand it, it's generally stated in roughly the terms that I have just given rather than being specific as to how—as to when the credit can be granted.

A Well, I think probably most—the regulations that I have read and the statutes that I may have read with respect to reinsurance credit doesn't deal with how you calculate the reserves but more with you can accept credit for these reserves if certain things prevail. That is, if the reinsurer is as qualified and certain other conditions.

Q Such as what?

A I can't recite them at the moment, but that the contract, the reinsurance contract have an insolvency provision is one of them. There are other things too which I might be able to refresh my memory if I look at a textbook or something. Right at this moment I can't think of them.

Q Isn't it correct that one of the purposes in unearned premium reserve is to provide a fund from which to pay future claims?

A The unearned premium reserve is solely for the purpose of paying future claims.

Q And it also serves the purpose—it also [174] serves as a fund from which to obtain reinsurance, does it not? You can use the fund—the insurance company that has received a premium can use that as a fund from which it will discharge its liability to pay claims or it can use it to obtain reinsurance and discharge its liability by reinsuring with another solvent qualified company.

A With the reinsurer using the money to pay the claim, yes.

Q Okay, so that if a company enters into an agreement by which it discharges its obligation to pay claims by reinsuring then it has applied its reserve in one of the purposes for which the reserve is required isn't that correct? That is to obtain reinsurance.

A If a company reinsures and it chooses to buy the reimbursement of claims through a reinsurer then it pays some of the premium for that purpose and as it pays the premium for that purpose—

Q I haven't said anything about paying premiums. I merely said that if the company that has received a premium enters into a contract and the contract provides that its liability to pay claims will be reinsured with another company and therefore, the other company will

have the liability to pay claims under that contract, then it has fulfilled one of the purposes for which [175] that unearned premium reserve must initially be set up under state law.

A Well, of course being an actuary we're taught that you can't have a contract without a consideration so I can't separate the question of reserve from the premium.

Q I am saying that the premium that is going to be received by the ceding company will be used to pay for that reinsurance.

A It is the premium—

Q I said I am assuming that the premium that is received will be used to pay for it. I haven't said anything about when the payment will be made. I am merely talking about the obligation to make the payment for the reinsurance and I'd like to keep the two subjects separate throughout the testimony if we can.

A What is it you are trying to get me to say. I don't understand.

Q I merely asked whether it was correct that one of the purposes of the unearned premium reserve was fulfilled when a ceding company has received a premium, obliges itself by contract to discharge its liability by reinsurance with another company, is that correct?

A Well, the purpose of the reinsurance—the purpose of the reserve, the unearned premium reserve is [176] to pay the claim. I don't understand how I answer your question by saying that by signing a contract without remitting the premium, that there is a satisfaction of that obligation for payment of the claim.

THE COURT: Well, if an insurer lays off its respon —all responsibility that it may have to pay the claim to another insurer having done that, would it any longer have any reason to maintain a reserve.

THE WITNESS: It had paid the premium for—

THE COURT: I don't care about that. It has laid off its risk exposure with another party. It is no longer going to be called in the ultimate sense at least to dig into its own pocket to pay off a risk under certain coverage. It may have to come up with it until it can get reimbursed but in the ultimate sense, it is going to have

from this day forward to put none of its own money behind any risk of loss. Now is there any longer any reason for it to maintain a reserve in respect to that policy or what you will under which the risk that it has laid off first came to it?

THE WITNESS: May I ask a question to see if I understand the question right.

THE COURT: Yes.

THE WITNESS: If you're saying that can an agreement be arranged between the ceding company and [177] the reinsurer and the reinsurer takes obligation of paying the claim without any question—we don't discuss the premium but the ceding company is totally relieved of this responsibility to pay the claim. No, I wouldn't see any reason that they'd have to maintain the reserve.

THE COURT: There's no longer any reason for the ceding company to maintain a reserve?

THE WITNESS: Right.

THE COURT: Irrespective of how the premiums are handled or whose holding them, isn't that right?

THE WITNESS: Right, and I take it this is a hypothetical situation because I don't know of any such thing existing in practice, but if that could happen—if that could be, yes, I agree.

THE COURT: I am just trying to find out whether it's your view that the touchstone of reserve maintenance is risk exposure without regard to anything else. That if you don't have that exposure, you have no credentials either requiring you or entitling you to carry a reserve in respect to a risk that you have, as I put it, laid off to another.

THE WITNESS: In practice, I am not aware of a situation where that occurs, but in practice what you have is that the reserve is established by whomever holds the premium and the reinsurance contract releases [178] you to that extent. Now, if it's possible to have an arrangement where you don't have to pay for it and you still get credit for it, why I would say that's right.

THE COURT: All right, at this point then, aside from the witness, may I say to both counsel, to ask rather, that sometime before the trial is over with I'd

like you to make an effort to come to an agreement as to for example in the initial period tell me what in relation to the risks written by American Bankers as the originating or ceding carrier, what was the measure of Consumers' responsibility, loss responsibility in respect to those risks and specifically if it was anything less than total assumption and was so limited in reference to some premium collections or any kind of premium consideration to please tell me what that is, because this witness and I don't want to go into it with him now because I just keep getting more confused, but he seems to be definite in view that as a reinsurer under the original what we'll call the original arrangement, Consumers assumed something less than American Bankers risks to the policyholder and to something less was this premium limitation and rather than going into that with him any further, I'd just like to let it lay with you all and so that before we're finished somebody could tell me what the risk is that they took.

[179] MR. MASINTER: Of course, Your Honor, I might suggest that that really is what this case is all about and it requires reading the basic underlying reinsurance treaty. It requires an actuarial interpretation. It requires a state regulatory application to it and I think what this witness is trying to say is that initially Consumer wrote 100 percent of the risk on the A and H and that under this reinsurance contract—excuse me, not Consumer, American Bankers wrote the risk initially under this period one treaty.

THE COURT: Right.

MR. MASINTER: And then Consumer reinsured it. Now, ultimately way on out many, many months or years, 100 percent of the risk would be borne by Consumers. There's no question about that.

THE COURT: That's what Mr. Borin told us, isn't it?

MR. MASINTER: And what this witness is also saying. Yes sir, that's correct.

THE COURT: Well, I don't get that from this witness.

MR. MASINTER: What they are both saying, as I understand it, and I've tried to live with it, is that in any

one month during this period of time during which all these policies are outstanding, there is a [180] limit on the exposure to Consumer and what they have done through this reinsurance arrangement is try and soften the blow by deferring it on out to a subsequent period of time.

THE COURT: Well, excuse me, do you mean when you say limit then are you saying that there's a temporary limit or an interlude limit or an intermediate limit?

MR. MASINTER: Yes, just for that one month.

THE COURT: So it's not a real limit. You see I thought—

MR. MASINTER: Not a dollar limit on the total exposure. The total exposure is still there.

THE COURT: I thought this man testified that if we had Consumer under your period one arrangement getting $10.00 a month reinsuring American Bankers A and H risk, all right, I understood him to tell me that if in the first, second and third months of this arrangement American Bankers had incurred no loss experience and in the fourth month, American Bankers incurred an $80.00 loss, that the limit of Consumers liability as he understands it under its reinsurance undertaking it would be $40.00 and that that would end the matter, not $40.00 plus an IOU to American Bankers cashable in the future. [181] That is my understanding of what he said.

MR. MASINTER: If you want to correct it and apply it to that specific example.

THE WITNESS: Right, if I might ask, months 1, 2, 3 and 4 American Bankers, there was no loss so they made some payment to Consumer.

THE COURT: $10.00 a month.

THE WITNESS: I didn't catch that part. No sir, I don't understand it that way. I understand that they owed them the $40.00 and an IOU for $40.00.

THE COURT: All right, very well, proceed.

MR. MASINTER: In other words, ultimately they still have that 100 percent exposure on that loss, but the only question is when they are liable for it. In the one month that you referred to, they are only liable for the

40, but in the next month they may be liable for the additional 40, or if there are other losses on top maybe even part of that will be deferred on out for a subsequent period of time.

THE COURT: Well, is he telling us sticking to our hypothet here that the so-called IOU can't be redemmed at a rate greater than $10.00 a month in the future?

MR. MASINTER: Exactly, the earned portion—yes sir, that's exactly right. And that's the limit of [182] the exposure in that month. Next month we start off with another dollar limit and it levels out.

THE COURT: If a man had a tourniquet on him, it would keep him from bleeding, at that rate he'd bleed to death in a week instead of a day but he'd still bleed to death.

MR. MASINTER: That's correct assuming you had continuous losses. Of course, if you assumed that for some months you don't bleed at all, then you can build back up some money with which to bleed some more, but the question is for an insurance company that does not have a huge loss in any one month that would render them insolvent or impair their statutory capital or do any other adverse—have any other adverse economic affect that would in a way let's say affect the policy and this would just level it out over a period of time and I think his testimony is to the effect that the purpose of reinsurance is not to absorb 100 percent of the exposure but to spread the risk, to defer the risk is a temporary measure and not a permanent measure. Is that correct?

THE WITNESS: Well, I certainly didn't mean to confuse the issue on that. I believe very definitely the $40.00 plus the $40.00 IOU in your illustration.

THE COURT: Is it your understanding, Mr. [183] Masinter, that from the standpoint of satisfying the regulatory authorities the reason that they are content to let Consumers in our situation get by with just giving this IOU for the $40.00 is that it's co-venturer, American Bankers has got $40.00 in the till?

MR. MASINTER: In the till, yes sir, and it's actually holding the reserve, so that they are liable for the risk and they are holding the premium dollar and they are holding the reserve. Consumers holds nothing.

THE COURT: Okay, so they've got the backup for Consumers IOU and this is why you think it's deemed acceptable by the regulator.

MR. MASINTER: That would seem to be the interpretation.

THE COURT: Well, it would to me, but I don't know if—

MR. MASINTER: Now, the question of counsel reaching agreement is really beyond the realm of possibility.

THE COURT: Now, that I understand it more, apparently I don't know—I'm going to be anxious to read his testimony because I'm going to have to—I started to say look in to the hearing aid market or something if I find that he really didn't say what I [184] thought he said.

MR. MASINTER: It's a difficult subject to comprehend just on hearing, and I believe I understand exactly what you're getting at and this really is the crux of the case and all of the cases that have considered this identical issue, namely the ITT Hamilton case in this Court, the Economy case in District Court in Indiana and Georgia Credit Life case in the District Court here in Georgia, all have focused on the same issue and the issue is whether or not Consumer or American Bankers had to hold this—or did hold this reserve and where is it includable, in whose reserve. American Bankers or Consumer and in all those cases, each one of them focusing on the issue that you just referred to, held that the reserve went with the premium.

And the argument was raised as counsel suggests that it follows the risk of exposure and none of those cases agreed with counsel's contention on that case and Mr. Eddy testified in each of those cases, just as he's doing here.

THE COURT: But didn't he tell us just a little while ago that this was really all the same thing because he felt that the premiums did follow the risk.

MR. MASINTER: Well, I didn't hear exactly that.

[185] THE COURT: Didn't he tell us exactly that?

MR. MASINTER: Well, he said that but I didn't hear him explain it in exactly the fashion that you seem to have interpreted his testimony. He said it in part, but I think it was sort of out of context.

THE COURT: Okay, proceed.

BY MR. SCHWARZ: (Resuming)

Q Mr. Eddy, I am referring to Plaintiff's Exhibit 2, the 1957 treaty. I wish you would look at it and identify it again for us. That that's what you understand it to be.

A I believe that's right.

Q In Article 5 regarding the payment mode, will you read this sentence please? The second paragraph in Article 5.

A "Consumer Life agrees to reimburse American Bankers before the 20th of the month, after such statement submitted for all losses actually paid during the preceding month on life policies and all losses actually paid during the preceding month on health policies plus any increase or less any decrease in the month in the amount of life losses reported unpaid and incurred and unreported".

Q Doesn't that mean to you that regardless of the amount of premium earned by Consumers during the [186] month, it would have to remit a check to American Bankers for the total losses paid plus losses incurred by American Bankers the previous month, regardless of how much it was.

A I suppose if you read that alone, you might come to that conclusion, but since you have to read the entire thing and read Article 2 isn't it—Article 1.

THE COURT: Well, Mr. Schwarz, give the witness the exhibit. We've got the point of departure here. That to him is dispositive. To you it's the first step. Now, you suggest that the purport of that is to be modified by giving weight to some other provisions. Now, could you specifically identify the provisions that have the effect of countervailing what would seem to be the literal purport of that.

THE WITNESS: May I read?

THE COURT: Right, you take your time and let's wind up with specific provisions.

THE WITNESS: "The liability of Consumer Life—

THE COURT: Excuse me, do you want all this on the record? I thought you were just thinking out loud here. When you get ready to put your answer—when you've called out these provisions that you feel do the job, then put them on the record, but feel free [187] to take whatever time you're required to select them.

THE WITNESS: All right, well, this is the last sentence of Article I which is what I was referring to. It reads "The liability of Consumer Life under said life and health and accident policies shall follow the liability of American Bankers except that the liability of Consumer Life arising under it, is reinsurance of said health and accident policies, is on a month to month basis and is limited solely to such amounts as shall become payable by Consumer Life under the provisions of Article 5 prior to the termination of this agreement".

MR. : And wasn't it from Article 5 that I just read?

THE COURT: Well, it's limited by Article 5. Isn't that where our base language came from?

THE WITNESS: That's not all of Article 5 though. Excuse me, that's all of Article 5, right.

MR. LANDON: Your Honor, if I could make a clarification there. That word "as shall become payable by Consumer Life" in that Article 1 was later changed because it was a typographical error. It's "as shall become payable to Consumer Life under the provisions of Article 5". I believe if you will look for instance on the amendment made on May 28, 1958, I [188] think in all those cases where it was copied thereafter.

MR. SCHWARZ: This is by virtue of the addendum of May 28, 1958.

MR. LANDON: And then again in the 10th day of November 1959, another one was made. You see just the word "by" was changed to "to". Someone had filled in a blank line or something. I think that's correct. Is that incorrect, Mr. Eddy?

THE WITNESS: That shows that way here, yes.

THE COURT: Which way?

THE WITNESS: The "to".

MR. SCHWARZ: I have a notation here, writing in the subsequent—

THE WITNESS: The amount shall become—such amounts as become payable to Consumer Life.

MR. LANDON: This changes the whole thing, but it does not go to your point. I just wanted to show that out, that change.

MR. SCHWARZ: Isn't it correct, Mr. Eddy, that until this amendment of May 28, 1958, regardless of the total of losses incurred during the month, Consumer would have to reimburse American Bankers for it regardless of whether it exceeded premium earned and the total premiums earned during the previous month?

[189] THE WITNESS: I certainly have to say I believe that from what I just this minute read, but if my recollection is that something else, I don't recollect at the moment about it, because my understanding of the agreement and maybe it was with the modification and it was that the limitation was to the amount of premiums earned while—during the term of the contract.

THE COURT: Well, Mr. Schwarz, does the government concede that in any event after May 1958 Consumers liability as a reinsurer under the A and H coverage with American Bankers was limited in accordance with this language of Article I that you all had been reading here to the general effect of what, premiums already received in conjunction with the risk. Would you please read the relevant language of this clause one again?

MR. SCHWARZ: Yes sir.

THE COURT: I mean aloud.

MR. SCHWARZ: "The liability of Consumer Life under said life and accident and health policies shall follow the liability of American Bankers except the liability of Consumer Life arising under its reinsurance of said accident and health policies, is on a month to month basis only and is limited solely to such amounts as shall become payable to Consumer Life [190] under the provisions of Article 5 prior to the termination of this agreement." That's as it was amended in 1958.

Under that reading we would agree that if there were any excess of losses in any one month over the premium earned, Consumer would not be obliged to make a payment of that excess immediately back to American Bankers, but this is no way limits its liability to pay those losses. The losses may be paid in the future but they will be paid by Consumer.

THE COURT: Now then, you're saying—your reading of this is that the only eventuality that could relieve Consumer from fully indemnifying Bankers for a loss incurred would be termination of the agreement?

MR. SCHWARZ: I don't believe that would even limit Consumer.

THE COURT: I thought it said—

MR. SCHWARZ: It said prior to the termination of this agreement, that ended the phrase, but I believe Mr. Masinter accurately stated that under the terms of the agreement, the ultimate liability for all claims rested with Consumer. The only contentious portion was as to what its liability was in any one month, that in any one month its liability was limited to the premium earned. To me it's a question of payment mode on the one hand versus ultimate liability on the other and I [191] think we could stipulate, if I am not mistaken, to that distinction which I think might help you.

MR. MASINTER: Well, if Your Honor please you know I have used these terms very loosely in the process of argument and they require a more definitive statement of tieing in the contract, because you know, it's just difficult to summarize a complex contract like this in just a few words and we're giving examples, but it does refer to the limit over in another section, so on brief we will—

THE COURT: Excuse me, now, besides Article 1.

MR. MASINTER: Oh yes, sir, there's tied in two sections of the contract and it does—Article 1 limits the liability and it does refer over to, it's limited solely to such amounts as shall become payable by Consumer Life under the provisions of Article 5 prior to the termination of the agreement.

THE COURT: Excuse me, though, 5 isn't a loss limiting clause from Consumers standpoint, is it? If it is I didn't understand it. I thought 5 said Consumers was on the hook for all of American Bankers losses. Didn't it?

MR. SCHWARZ: I think the problem is that there are—

[192] THE COURT: Excuse me, Mr. Masinter, would you read clause 5, please, or Article 5.

MR. MASINTER: Article 5 says, "American Bankers agrees to pay monthly to Consumers based on the statement set forth in Article 3 for the preceding month and payable at the same time 87 and 1/2 percent of the premiums collected, less any premiums returned on all life policies and 87 and 1/2 percent of the premiums earned on all health and accident policies" and then it goes on to say Consumer agrees to reimburse.

THE COURT: Well, don't tune me out there. Read that please, Consumer—

MR. MASINTER: Now, first paragraph of Article 5, the one I just read was amended by subsequent agreements none of which seem at this quick reading to have any general affect on the substance except to change the amounts. I think that's correct.

THE COURT: Very well.

MR. MASINTER: Then the paragraph goes on to say that "Consumer agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted for all losses actually paid during the preceding month on life policies and all losses actually paid during the preceding month on health and accident policies plus any increase or less any decrease [193] during—I guess that's such month, I can't read it—in the amount of health and accident losses reported and unpaid and incurred and unreported.

THE COURT: That's not a loss limiting clause from the standpoint of Consumer, I wouldn't think. Now, is there something else? I thought you indicated that there was another clause in the contract beside this clause 1 that you read earlier, that limited Consumers liability.

MR. MASINTER: No sir, I think that clause 1 limits it to the earned portion on a month to month basis.

THE COURT: And that's the only limiting clause in the contract?

MR. MASINTER: Yes sir.

THE COURT: All right, and so the two operative or viable clauses for our purposes you've now touched on.

MR. MASINTER: Yes sir.

THE COURT: One and five.

MR. MASINTER: Yes sir.

THE COURT: Okay.

MR. SCHWARZ: Your Honor, I would just like to add one thing. If the Plaintiff were to contend that upon the termination of the agreement, any excess of losses incurred over premiums earned would be terminated [194] and American Bankers would have to assume that loss itself, then I think other provisions of the contract ought to be referred to now to clarify that.

THE COURT: Well, just a minute, do you so contend, Mr. Masinter? I asked the question from just listening and I heard this termination. Do you contend that Consumers liability to reimburse under its reinsurance obligation to American Bankers can be curtailed or extinquished by termination of this agreement? He says he didn't think you did and I don't—

MR. MASINTER: Well, I think just a normal termination would not. Of course, if it were a termination due to insolvency, for example, the liability—that's a different question and if Consumer became insolvent, then American Bankers would have to stand good on the full load, full amount, but just a normal termination of policy under the reinsurance treaty, I don't think that's our contention.

MR. LANDON: Maybe that is a question for the expert to consider exactly that.

MR. SCHWARZ: Well, the expert—that's a legal question. I don't think the expert is qualified to consider that.

THE COURT: Well, I take it that in the [195] ordinary course it's agreed that Consumer could just not tell American Life the agreement's at an end and you pay your own losses. This would not be in contemplation, is that right?

MR. LANDON: That's correct, Your Honor.

THE COURT: All right, proceed.

BY MR. SCHWARZ: (Resuming)

Q Mr. Eddy, isn't that correct that on casualty insurance, including credit accident and health insurance involved here, the premium is always payable by the insured at the outset of the policy or within several days after the outset?

A In what type of insurance are you speaking of?

Q Well, in the insurance involved in this case, the credit life and the credit accident and health?

A As far as I know, it was, yes.

Q Isn't that always the case?

A No, not by any means. You can have a monthly outstanding balance of credit life or credit A and H. As a matter of fact, daily outstanding balance—

Q I'm sorry, I can't hear you.

A I says as a matter of fact, currently lending institutions are offering daily outstanding balance [196] coverage. In term of these agreements, it was monthly outstanding balances on a group basis.

Q Do you recall your testimony in the ITT Hamilton case?

A Well—

Q Did you testify in that case?

A Yes, I testified in it.

Q I appreciate it if you would read this question that was put to you in that case and the answer to the question is a bit laboriously stated, so please read it slowly.

THE COURT: Mr. Masinter, you can approach the witness if you want or do you know what this is all about?

MR. MASINTER: I have no objection to it though, Your Honor. I assume that he's just going to try and impeach what he just said.

BY MR. SCHWARZ: (Resuming)

A Would you indicate what page that is?

Q I am referring to page 173 in the transcript of the trial in the ITT Hamilton case versus the United States. It's now entitled Penn Security versus the United States.

A Okay.

Q Do you understand the question and the [197] answer that this question was put to you in that case?

A Yeah, I believe I do.

Q Could you read the question as it's stated there and the answer?

A "Q Can you think of any situation involving insurance and not reinsurance where except for the examples you gave me before involving delay or late payment of a premium due at the outset of coverage or delay in paying because of grace period to specify in the policy where a company will accept a liability when it has not received the premium for that liability, unconditional liability at the outset of the coverage or where it doesn't have a right to receive it at the outset of the coverage on the policy." You want the answer read too?

Q Please.

A "A No I don't believe so. The only thing that would remotely be similar that would be the case where you have casualty type coverages where the premium is, the final premium is not established until the expiration of the contract. This is generally with corporations, large types of coverages, fire and casualty type coverages, but even then I don't think that there is any and I am certain the insurers have a right to the premium from the outset and they always collect [198] some sort of advance against the premiums, pretty well calculated nearly what's going to be required."

Q Now, certainly in connection with the credit accident and health coverage involved here, the premiums are always paid at the outset?

A Yes, I believe that's true.

Q So the only question as far as who is going to establish the reserve was—the only question as far as the relationship between premiums and who held the premiums and who held the reserves was between the

insurance companies, is that right. There was no question?

A The policyholder wasn't going to hold a reserve, no.

Q Okay, that's the only point I was really trying to make.

Now, on an individual policy when let's say $1.00 of premium is received by the ceding company, it sets up an unearned premium reserve of $1.00, is that correct?

A You are speaking of accident and health?

Q Yes.

A Yes.

Q Now, if on that policy say several months later after a portion of that premium has been earned, [199] a claim is filed, then a claims reserve must be set up, isn't that correct?

A Right.

Q And is that reserve called unpaid losses?

A That would be unpaid claims.

Q And what happens to the balance of the unpaid premium reserve at that time?

A Well, because you can't take these calculations on an individual policy basis if we're going to talk about averages, because you might have a $100.00 claim on a $1.00 premium. You are not speaking of that. You are trying to, say on average claims filed, can we make that assumption?

Q I haven't made any necessary connection between the amount of the claim and the amount of the premium?

A Well, then let's suppose that your term of coverage, initial term of coverage is a year for this illustration and that at the end of six months, we have a claim, would that fit with your illustration?

Q Yes.

A And that claim is for 25 cents, is that all right? Then at the end of the six months we would have by that time released as earned premiums 50 cents out of our dollar given pro rata earning of the premium, [200] of which we would have paid 25 cents in claims and 25 cents to surplus. If we had released the 50 cents in

earned premiums daily and the claim occurred on the very last day so that we had already released the surplus 50 cents and the claim was incurred, that claim of 25 cents would have to come out of surplus. Reserves would be established then out of the surplus account and not out of any other accounts and I think that would be important with the question that you asked earlier, Commissioner, as to any liability in the case of the 1971—I mean, '57 or period one treaty where claims, accumulated claims were more than earned premiums at any point. Any liability that might have been established because of that by Consumer would have to had come from surplus and would not have been unearned premiums.

In this illustration, the unearned premium reserve remains the 50 cents for the balance of the 12 months period which has not yet expired.

Q Are you familiar with the kind of reserve on accident and health coverage called an additional reserve for non-cancellable accident and health policies?

A Yes, I am.

Q Will you define that reserve for us please?

A Right, non-cancellable life and accident and health —I mean non-cancellable accident and [201] health insurance is the type of insurance that is sold for extended years of coverage and on a non-cancellable basis with a guaranteed or fixed premium, which is quite different from the type of accident and health insurance that is normally sold and referred to as commercial insurance, or for that matter, in this case, where the term period is short, relatively short.

During a long term policy, health will deteriorate to the extent that a risk which starts at age 35 will become much more susceptible to illness by age 65 and if we charge a fixed premium every year of $1.00 for a benefit that remains level and the dollar at age 35 will be more than necessary to pay claims, but it will be less than adequate to pay the claim at 65.

The insurance industry recognized the need, therefore, to reserve some portion of this dollar and save it in the early years to help offset this deficit in later years.

Now, during each year of the 35 year—30 year period from age 35 to 65, at the valuation date, the dollar premium paid that year would be and let's suppose in this illustration the policy was issued on July 1, so that the valuation date on December 31st each year was just halfway through that one year's coverage. There would be an unearned premium established [202] on that valuation date of 50 cents representing the unearned portion of the dollar for the balance of this policy year, but in addition to that in the reserve in addition to the unearned premium reserves that you referred to, then if some few cents saved from the dollar at age 30, added to interest and a few cents at age 31 and so forth, accumulated in addition to this unearned premium reserve, and it together with the dollar in later years paid the claims as projected. Is that answer sufficient?

Q Now, is the additional reserve for non-cancellable policies referred to the one which will include these additional several cents that are added each year in order to build up a fund to overcome this fact that morbidity will increase over time and that the future premiums will not be sufficient to cover the future benefits.

A Is it what?

Q Is the fund into which these few cents that you mentioned added to the additional reserve for non-cancellable policies that I asked you about?

A That fund is the additional reserve, yes.

Q I think that's what you were saying. I just wasn't sure that you had made it clear that the reserve I asked you about was the one to which these [203] additional monies would be placed. All right, now, can you compare that reserve to the life insurance reserves which you described earlier? On life insurance coverage?

A Yeah, well life insurance reserve is quite similar with one exception and that is that—

Q Would you state the similarity first please?

A All right, the similarity is that a policy issued at age 35 to term insurance policy to expire at age 65 for a dollar premium is an example. The dollar being more than sufficient at age 35 and less than sufficient at age 65 to meet claims. Some portion of the dollar would

be saved each year and accumulated at interest to become this life insurance reserve fund which would be added to the dollar at later years to meet the claims, but in addition to that on December 31st every year, during the years between 35 and 65, the unearned portion of the net premium—in this case, let's say 42 and ½ cents, ½ of 42 and ½ cents would be set up in addition to this accumulation I spoke of, which represents or is comparable to or parallels the unearned premium on the accident and health.

The sum of the unearned net premium on life insurance for the unexpired portion of that current year plus this accumulation becomes the life insurance reserve. Under the guaranteed renewable and non-cancellable accident [204] and health, this accumulation of the few cents comparable to the accumulation on the life policy, plus a gross unearned for the balance of the period are added together to become the reserve of accident and health policy.

Q And if the coverages that a company wrote were all long term coverages of the kind we are just discussing, wouldn't it be correct that you would have relatively large life insurance reserves, large additional reserve for non-cancellable accident and health policies and relatively smaller unearned premium reserve on the accident and health policies, so for over a long period of time the non-cancellable reserve would become very substantial whereas the unearned premium reserve on the accident and health would relate only to the one year's coverage, say if the policies were payable on a yearly premium basis.

A Well, certainly an answer to that question would depend on the composition of the company and all that sort of thing, but generally speaking, this additional reserve on accident and health policies is relatively small, related to their unearned premium. It is in fact pennies out of dollars.

Q Who maintained the unpaid loss reserves under the 1957 treaty?

A Under treaty one the American Bankers [205] maintained the unpaid loss reserves on accident and health policies.

Q American Bankers maintained them?

A Yes.

Q And on treaty two?

A On treaty two, I believe they retained—had the reserves for their portion but I'd have to read the treaty again to be sure about that.

Q During the period of years during which the 1957 treaty was the sole treaty in operation, was it your understanding that Consumers was an unauthorized reinsurer in the state of—under the laws of the State of Florida where American Bankers was domiciled?

A No, as a matter of fact I believe that they were acceptable and I don't know if they had the status of authorized or not, if Florida gave out such statuses but I believe that they were acceptable and believe that—as a matter of fact, it doesn't matter in these treaties because they didn't try to take credit for any reserves held by Consumers. Yes, they did on the life insurance policies and they were permitted to take the reserves, so I presume they were acceptable.

Q Can you name a state which does set up a status of unauthorized reinsurers?

A Well, probably every state has—in my [206] experience with many states has been that they do have many time loose regulations—rules about what is a qualified reinsurer and what is not and quite frequently those states that have very formal rules permit an unqualified reinsurer to still set up reserves and its insurance companies—the state's insurance companies to take credit for it provided the unauthorized reinsurer makes certain deposits and certain conditions, but the rules are varied, very varied amongst various states as to what's qualified and what's not qualified.

Q Now, under a reinsurance treaty with the premiums paid over to the reinsurer at the outset and when it reinsures say 100 percent of the risk of the reinsurer, if the reinsurer is unauthorized in the state, the state may prohibit the ceding company from taking credit for its unearned premium reserve and letting the reinsurer set it up. Isn't that correct?

A Again, Mr. Schwarz, we're speaking of hypothetical situations and I think that generally in practice that

doesn't occur because people don't deal with each other when that's the problem, but yes, I agree that if companies did deal with each other and that would be the problem, that would be certainly one of the requirements.

Q And you have never run into the situation [207] where perhaps the parties thought that the reinsurer was qualified or through some other circumstance it turned out that upon examination the credit was disallowed because the reinsurer was unauthorized.

A I don't recollect where it was under examination disallowed, but I'm sure that those occasions have existed and I have been—have had experience where companies thought that the allowance would be permitted but it would not have been permitted if they had gone on to annual statement or reporting time under those conditions, but there are lots of ways in which companies have been able to change that or alter that, and one of them is similar to the treaty one on the accident and health here.

That is, that the ceding company maintain the reserves although the reinsurance provided on some earned basis that the reinsurer take the risk. They call that modified co-insurance if that would be of any interest to you.

Q Well, modified co-insurance is a kind of arrangement that would be set up at the outset in order to permit the reserve to be in a certain place and the premiums to be in a certain place?

A Well, modified co-insurance is precisely in many of the cases for the purpose I just spoke of. [208] That is, to keep—to circumvent the question of whether or not the ceding company can take credit for the reserve. It simply holds the money there before it holds the reserve. There are other reasons of course, for modified co other than that, but that's one of them.

MR. SCHWARZ: Your Honor, could you just give us one or two minutes please?

BY MR. SCHWARZ: (Resuming)

Q Mr. Eddy, we had a controversy earlier about the provisions under Article 5 of the 1957 agreement. Was the testimony that you gave in your direct examination

based upon the assumption that you used there that losses incurred in excess of the premium payable in any month were not then due? And perhaps not due at all?

A I'm not sure I understand the question, but I am certainly delighted that you gave me a chance to mention again an agreement. The addendum was dated 28th of May '58 and is retroactive to the initial date of this contract and that's what I really had in mind, and just couldn't recall it. It modified Article 1 to say, the payments—the liability was limited to payments to Consumer by American Bankers rather than by Consumers to American Bankers under Article 5, so just to straighten [209] that point out. That's why I had that understanding.

Now, your question was,—would you please repeat it?

Q I think you've answered it.

THE COURT: I don't think he's answered it.

BY MR. SCHWARZ: (Resuming)

Q Was the testimony that you gave based upon that term as amended, being absolute liability on the—on Consumer Life or only a temporary liability, that is a monthly liability.

A Well, in the illustration given—

THE COURT: You mean liability or limitation? That's actually the limitation on liability, isn't that what you're driving at?

MR. SCHWARZ: I think so. I'm trying to distinguish—

THE COURT: All right, is it permanent or temporary?

THE WITNESS: Well, I think that it had as near illustration, a $40.00 immediate obligation to remit to American Bankers and a $40.00 IOU which would have been taken out of future earnings.

THE COURT: All right, and is it your understanding then following that one step further, that [210] the reason the regulatory authorities sanctioned Consumer just having an IOU for its remaining $40.00 is that the other party to the reinsurance contract has a $40.00 reserve that it's maintaining? That will be diminishing as Con-

sumers' IOU diminishes in direct proportion the reserve will.

THE WITNESS: Well, Commissioner, we don't know in fact that that situation occurs so I can't answer, whether the—in my opinion, that's the reason they would not have required it, but I don't think that a situation came up—

THE COURT: You don't know as an expert. You have no thought that it might be or indeed that it is the fact that one party to the risk is maintaining in hard dollars a real reserve that the regulatory authorities would condone another party to that risk maintaining no reserve at all, except its promise and its IOU, as we call it.

THE WITNESS: Yes sir, I agree with what you just said. That is, I do believe that.

THE COURT: But for the hard case reserve—

THE WITNESS: The hard cash.

THE COURT: —they wouldn't be too interested in the IOU or no IOU would they?

THE WITNESS: No sir, they would establish [211] the reserves on somebody's books.

THE COURT: All right.

BY MR. SCHWARZ: (Resuming)

Q There is no—the unearned premium reserve liability is not a sinking fund in the sense that that term is used in accounting parlance, is it Mr. Eddy? It is not a segregated fund of money which must be used for a particular purpose. It's merely part of the general admitted assets of the company which must be maintained in a certain way in order to pay claims, is that correct?

A There's no segregation of assets with respect to the reserves, right, or for specifically the reserves, no. They're comingled with the other assets of the corporation.

Q You mentioned that one of the purposes of reinsurance is to spread risks?

A Yes.

Q By that did you not mean that the ultimate risk was to be spread between two companies under a typical

reinsurance arrangements. At least, that is one of the purposes—in other words, if reinsurance is to spread the ultimate risk of liability between two insurance companies rather than for one company to incur the entire liability?

A No, I believe that in a—in the main [212] part, the essence of reinsurance, individual policy reinsurance is to spread the risks over a period—a number of accounting periods for the ceding company and it pays a price for that.

Q Now, one possibility is to spread it over a period of time in terms of temporary deferring the payment?

A And that essentially is what I believe reinsurance accomplishes excepting for the catastrophe reinsurance, of course.

Q You mean excessive loss reinsurance?

A Well, excessive loss will still be this type of spreading the risk we're speaking of, because the reinsurer is eventually going to get his money back, but catastrophic losses, I think, is a real spreading of risk over a lot of companies, not just between two companies.

Q Wasn't it common that a company will write all of a certain type of risks, say up to $100,000.00 and if it gets a policy for $250,000.00 it will automatically reinsure 150 with another company or will do it, if not automatically on a case by case basis?

A Precisely and it's the—

Q Is that a common type of reinsurance?

A That is the most common type and it's the [213] summation of those excess 150,000s that are spread for the ceding company over a period of time by the reinsurer.

Q All right, now spread for the period of time once that reinsurance is obtained, the ceding company is off the risk for the 150 forever, isn't that right?

A Excepting to the effect of the experience refund formula.

Q If an experience refund formula exists—

A Which is the majority of the cases.

Q Which what?

A Which is the majority of the cases?

Q Is it true that in the usual situation involving an experience refund only a partial refund will be likely, regardless of how good the loss experience is so that in actuality the ultimate risk is shared by the insurer and the reinsurer.

A Well, I don't know of any reinsurers that aren't making profits, in reinsurance operations so I can't say—I don't in practice that's true.

THE COURT: How about the ones that took the Equity Funding risk?

THE WITNESS: Well, they didn't make it. That's not the type of reinsurance he's speaking of, of course, Commissioner. He's talking a—

[214] THE COURT: I thought you said that the reinsurers were all doing fine.

THE WITNESS: Well, they did—well, in that particular instance of Equity Funding type thing, wasn't the typical type reinsurance we're talking about.

THE COURT: I'm sure the reinsurers would join you in that hope.

THE WITNESS: Well, unfortunately I worked with some of the companies involved in that and they too are making profits but not because of that account.

BY MR. SCHWARZ: (Resuming)

Q Under the second treaty in this case, the three percent figure that was to be earned by American Bankers as reinsurer was a flat three percent figure, isn't that correct? Regardless of the loss expereience, they were going to earn three percent.

A I don't understand it that way.

Q Do you recall the testimony this morning where we made some great effort to clarify the significance of the three percent figure under that treaty?

A Yes, I do and I was disturbed at what was being said because first of all, American Bankers for its 80 percent of the risk received the 40 cent premium, 40 cent commission had been paid out and in fact, a guaranteed 40 cent commission had been paid out and was [215] gone. Now, for American Bankers to get its three percent, loss ratios had to be less than 47 percent, not 97 percent as was spoken of this morning because 50 percent commission was paid.

Q I didn't—

A Now—

Q Excuse me, I didn't really mean to re-enter us into this tremendous muddle that I thought we had resolved about the second agreement. Perhaps we can stipulate that under that treaty number two, as the testimony evidenced this morning, American Banker was going to earn three perecent and only in the remote unlikely possibility that over 20 quarters, there would be a deficit in the experience refund calculation would they ever stand any chance of not getting that three percent.

MR. MASINTER: I think you asked the question of the witness.

MR. SCHWARZ: I am asking you, isn't that the understanding that was reached in the testimony this morning? Can't we stipulate to that?

MR. MASINTER: First of all, I think I would prefer the witness to answer the question.

MR. SCHWARZ: I guess I will just have to pursue that treaty in some detail again to clarify this.

[216] THE COURT: Well, I don't believe I'd be as interested in what this witness thought of the treaty as what Mr. Born thought of it and we went through all of that with Mr. Born and I thought finally he was very definitive and very clear and I would suggest that you just let that matter lay where it is and not be too concerned about what this witness thinks about the three percent.

We'll have a ten minute recess.

(Whereupon, at 4:45 p.m. a short recess was held.)

THE COURT: Counsel ready? Proceed.

MR. SCHWARZ: Your Honor, we have no further questions of this witness.

THE COURT: Mr. Masinter, redirect.

MR. MASINTER: The witness may be excused. We have no further questions.

THE COURT: All right, in that event, I'd like to ask him a couple questions and that may cause either or both of you to want to put something further to him.

Speaking to you as an expert in the insurance field, do you understand why we're interested in determining who ought to be carrying these reserves, Mr. Witness.

THE WITNESS: As I understand it, the question [217] is to determine if Consumer qualifies as a life insurance company or not.

THE COURT: All right now, and that's really the only pertinence. Just think along with me, if you will and I'll say, Mr. Masinter that this is what kind of bothers me about what I've seen in the decisions up until now. I would say I think particularly the one of our own Commissioner Fletcher. I seem to get the idea that there's been an undue preoccupation with or fixation on these reserve inquiries and considerations as sort of an end in themselves that this is what we're shooting for.

Now, and you speak to this, Mr. Witness, if I'm wrong about this. If we have got an organization that's doing two different things, one of which is writing some life insurance and the other thing happens to be writing some other kind of insurance and we are trying to figure out just as laymen what is this outfit's principal activity. Well, we might think to ourselves well maybe what's principal is what's most profitable for them. Well, we're not going to use that index. Maybe what it's principally involved or engaged in is that which generates the principal gross receipts for it. We're rejecting that too.

Now, if we were to say, recognizing in the first instance as the Supreme Court has said and nobody really [218] challenges that the essence of an insurer is risk assumption, that old Lagrese case in the Supreme Court where the carrier sold a life contract and a single pay annuity to be co-extensive and they said well, that wasn't insurance because there was no risk.

All right, if risk is deemed then a hallmark of an insurer and we've got somebody who's insuring in two different areas, one of which is life insurance and we're trying to figure out what he's principally engaged in and we decided we were going to do it from the standpoint of looking at reserves, what would you think just as an original proposition that you would be looking for in the context of reserves if your purpose in looking

at them at all was to try and reach some conclusion, some impression in your own mind as to what he was primarily doing.

THE WITNESS: Commissioner, would it be all right for me to take a few minutes of yours and the Court's time to give you an illustration that I don't think is going to help answer your question, but it will tell you why I can't answer your question.

If we were to take—

THE COURT: Are you saying that you're about life insurance like Justice Stewart was about pornography. He can't define it, but he knows it when he sees it.

[219] THE WITNESS: Or enjoys it when he sees it. No sir, I don't think that I'm going to say that, but I wanted to make an illustration. There's an arbitrary ruling—statute which is arbitrary—some rule has to be there, as to the definition of life insurance company. That rule really is whether 50 percent of the reserves are life insurance reserves, but if I could just give you an illustration or one simple illustration, I can demonstrate why it's difficult for me to give you an answer as to what you would look for.

THE COURT: Yes, of course, you can do that, but I was trying to get you to divorce yourself from what the statute says or didn't say. I was trying to just get the benefit of your expert knowledge as to if left to your own devices and I laid before you a company that was doing two different kinds of insurance business and one of which happened to be life and I said to you which do you think is its predominant activity and I'd like you to tell me this by inquiring into its reserve situation, what would you look for and I was trying to get you away from the statute, but you go ahead and say whatever you wish.

THE WITNESS: Well, first of all, to try to answer your question and if I were to try to decide whether a company was a life insurance company or not, the question [220] wouldn't come to my mind that I should test to see whether it issued more accident or health or more life insurance because those two types of insurance have been such common companions since the end

of the depression years that one hardly thinks of a life insurance company that doesn't sell accident and health insurance and to some extent vice versa, but the real difficulty comes with the arbitrary requirement which evolved through regulation of putting up gross unearned premium reserves for accident and health which in the early years was certainly reasonable because of the refund problem and refunding the total premium and not just the net premium, but that doesn't exist any longer, but take an insurance company that just sold one policy. A credit policy that had credit life and credit accident and health insurance. A one year policy, $100.00 loan for 12 months period. The premium collected for the life insurance would be $1.00.

The premium collected universally almost for the accident and health insurance would be $2.20. Now, surely that one policy isn't anymore life insurance than it is A and H insurance and yet the reserves on A and H would be $2.20 and on the life would be 42 and ½ cents, so it would fail to qualify by grand margin. So it's difficult for me to answer your question what would I look for as to distinguish one from the other.

[221] THE COURT: Are you telling me that if it were up to you, you wouldn't make any distinction between life and A and H because they're so kindred, they're so companionable, they're found so much together and secondly, that if you were going to undertake such a distinction you wouldn't do it by reference to reserve considerations?

THE WITNESS: I think maybe the fairest and ultimate result would be to compare apples with apples and compare life insurance reserves with morbidity reserves rather than gross premium reserves, but that's purely my opinion and certainly that I know of, anyone else's. That way you would be certain—

THE COURT: All right, morbidity reserves in A and H, you're speaking about?

THE WITNESS: Yes sir.

THE COURT: All right, now would you say that the morbidity reserve in A and H should be fastened to the person who's assuminng the morbidity risk?

THE WITNESS: I've been trained to think of it in terms of who has the premium.

THE COURT: I can see what you're talking about even though I'm uninitiated in the matter that within the reserve context morbidity would be what would appeal to me in conjunction with the reserve. There's not much point in talking about a reserve in the context of something [222] other than what I'd call risk of exposure, risk of exposure to me I think is what you mean when you say morbidity and there's no point in reserving other frill receipts and what have you, so I'm with you that far, but then when you turn around and tell me that well, but who maintains that reserve you don't think really should be determined by who's bearing that morbidity risk but rather by who's holding some premium dollars. I just don't understand that at all.

THE WITNESS: Of course, I based that statement on the assumption that there is some sort of contractual arrangement between the two parties which forced the person holding the money to eventually pay it to the person who was holding the risk.

THE COURT: You're assuming that the risk incidence aligns with premium receipt in the long run if not the short run.

THE WITNESS: Yes sir.

THE COURT: Mr. Masinter, anything further of this witness.

MR. MASINTER: No, Your Honor.

THE COURT: Government.

MR. SCHWARZ: Only one question based on what you said.

RECROSS EXAMINATION

[223] BY MR. SCHWARZ:

Q Couldn't the parties have agreed here, Mr. Eddy, to produce the same financial affect by altering the amount of the reinsurance premium? In other words, have the premiums remitted to the reinsurance, but adjust the unearned premium to give effect—just the reinsurance premium to give affect to the fact that the investment

income, et cetera would be earned by Consumer rather than American Bankers, for example.

A Would they—I am not sure I am following that. Are you saying could they have transmitted some lesser premium from American Bankers to Consumers than American Bankers had received from the borrower, from the debtor?

Q Well, in this case, the '57 agreement, the reinsurance premium was 87 and ½ percent.

A Yes.

Q And one of the considerations I should think that went into the setting of that premium was the fact that American Bankers was going to hold these unearned premiums and get to earn the investment income on them while they held them.

A Yes.

Q As a financial matter, wouldn't that make sense to you?

A Right.

[224] Q So if they agreed that the reinsurer, Consumers would hold those unearned premiums, rather than American Bankers couldn't they have say reduced the reinsurance premium somewhat so as to give American Bankers a little more money for its willingness to enter into this agreement, since it wouldn't be getting it by way of investment during the period it held those unearned premiums.

A I'm sorry, I don't think I completely follow you. I believe that other arrangements could have been made. I'll say that and the one thing that we can't overlook, however, is that shortly after they entered these initial agreements, they did commence to pay commission which increased the problem because you say they held the money and got investment income but they only held what they received, so if you—as a matter of fact it was detrimental to American Bankers to hold these reserves after commissions were paid because they were having to take money out of their surplus account in addition to the premiums they received.

After commissions were paid in '59 of 20 percent, they only got 80 cents on a dollar, they had to establish a

dollar of reserves. Well, they had to take that extra 20 cents out of other funds that would be otherwise available for other investors. Now, as [225] long as the other investments were restricted to the statutory capital surplus, it made no difference because you can put your reserve money and your capital and surplus in the same type of investment, but because American Bankers was in another business, namely ordinary insurance and you can get a considerably better rate of return on your investment than four or five percent which is what they could get on the statutory surplus in reserve, but they were actually giving up money, earnings to so-called invest the reserve, but from Consumers point of view sure they would have been better off to, from the investment income point only, to get more money in, but they too would have had to establish reserves out of other funds for the same arguments and they were out borrowing money at a higher rate than they could earn on the reserve, so they would have been foolish to have gone further into that, in my opinion.

MR. SCHWARZ: No further questions.

THE COURT: Mr. Masinter?

MR. MASINTER: No sir.

THE COURT: Thank you, you may be excused.

MR. MASINTER: We have one other witness, Your Honor.

THE COURT: Off the record.

(Discussion off the record)

[226] MR. MASINTER: Plaintiff calls Mr. George Floyd.

THE COURT: Raise your right hand. Do you solemnly swear that the testimony you are about to give will be the truth, the whole truth and nothing but the truth, so help you God.

MR. FLOYD: I do.

THE COURT: Please be seated.

THE REPORTER: Would you state your name and address for the record please.

THE WITNESS: My name is George Floyd. I live at 254 N. E. 115th Street, Miami, Florida.

GEORGE FLOYD, a witness produced on behalf of the Plaintiff, having first been duly sworn, by said Trial Judge, was examined, and in answer to interrogatories, testified as follows:

DIRECT EXAMINATION

BY MR. LANDON:

Q Mr. Floyd, would you tell us by whom you are employed, please?

A I am with American Bankers Life Assurance Company of Florida.

Q What is your position with them?

A Vice-president.

Q Are you familiar through your work, your [227] responsibilities there, your discussions with others and your own activities with the reinsurance agreements with which we are concerned today?

A Yes.

Q Are you familiar with the annual statements also called convention reports that are required to be filed by American Bankers on an annual basis, their annual statements?

A I am familiar with them. I do not prepare them, I do not know all the facts of them.

Q Right, but you have seen them?

A Yes.

Q And discussed them with others and are familiar with the business that's reflected there.

A Correct.

Q Can you tell me as a result of your familiarity therewith under the treaty which we have referred to today as treaty one or the 1957 treaty between Consumer Life Insurance Company and American Bankers as to the accident and health insurance which was reinsured by American Bankers with Consumers Life, did American Bankers maintain unearned premium reserves on that accident and health business?

A They did.

Q Were those reserves reflected on their annual [228] statements for the years in question?

A Yes.

Q For the treaty commencing in 1962 between the same parties, but as to which Consumer Life was the direct writer and American Bankers was the reinsurer and as to which the accident and health business was reinsured totally at once, did American Bankers maintain the unearned premium reserves on that business?

A Yes, I spoke with our treasurer before I left and he said that was included in our total reserves in our annual statement.

Q They were reflected then on the annual statements?

A Yes.

Q Does American Bankers—is American Bankers subject to the same sort of examination reports and examinations by the various state insurance commissions or departments of insurance or whatever they're called in each state that you have heard us discuss with Mr. Born earlier.

A Yes, every three years we have one.

Q The tri-annual examination?

A Yes.

Q During the period in question from 1957 through 1964 were such examinations made of American Bankers?

A Yes, they were.

[229] Q I show you Plaintiff's Exhibit 18, 19. On Plaintiff's Exhibit 18, is this a copy of the report made of American Bankers in the year 1960?

A Yes, it is. Correct.

Q I show you Plaintiff's Exhibit 19. Is this a copy of the report of examination made in 1963?

A I believe it to be, yes.

Q Were any of the examiners at all concerned, or did they raise any question about the propriety of American Bankers maintaining the reserves on the subject A and H business that we have discussed?

A No, not to my knowledge.

Q To your knowledge, has that question ever been raised by any state regulatory agency?

A Not on American Bankers maintaining the reserves.

Q Would it have been proper in your opinion under treaty one, the first treaty for Consumer Life to have

maintained the reserves on that accident and health insurance?

MR. SCHWARZ: I object to that question. I don't believe any foundation was laid for his qualifications.

THE COURT: I think that's probably valid.

MR. LANDON: Yes sir.

[230] BY MR. LANDON: (Resuming)

Q You heard Mr. Schwarz say immediately previously that one of the advantages to the person holding the reserves was the investment income received off those reserves. Did you hear that statement?

A Yes, I did.

Q Was that an advantage to American Bankers. Did you in fact hold physically the reserves we're discussing and receive investment income therefrom.

A That is always an advantage to the company holding the reserve to invest those funds outside—a fact of a life insurance industry.

Q And that was the fact in this case? These reserves.

A It was.

Q I have asked Mr. Schwarz whether or not—and I am not asking him for an ultimate decision right now—he would require copies of your entire annual statements to be submitted as evidence or whether he would accept copies of the Schedule S and Exhibit 9 for the years 1958, '59, '60, '62, '63 and '64. Would you take a look at these exhibits? This is Plaintiff's Exhibits #15, determine if, in fact, these are copies of your schedule S and Exhibit 9 for those years. For the years 1958, '59 and '60.

A These appear to be correct.

[231] Q I show you Plaintiff's Exhibit #13, subdivisions A through C and ask you the same question. Are those copies of those schedules for the years 1962, '63 and '64 respectively?

A I believe them to be so.

Q With respect to Plaintiff's Exhibit 19, the annual—the report on examination as of December 31, 1963, can you tell me which states participated in the examination?

A Yes, they're listed on the front of the sheet as Arizona, Arkansas, Georgia and Florida and in the last

page, '68, they are signed by the representatives of the State of Florida, the State of Georgia, representing zone 3. The State of Arkansas and the State of Arizona representing zone 6.

Q Who were the various examiners on those states please?

A It says State of Florida is Mr. Melvin Courson, the examiner. The State of Georgia representing Zone 3 was Mr. B. Folger West. The State of Arkansas representing zone 5 is Leslie T. Myers and the State of Arizona representing zone 6 is Mr. Thomas L. Robinson.

Q Can you tell from this examination report or do you know from your own knowledge of this examination as of December 31, 1963, who was the chief examiner [232] for that examination?

A Normally, it is the state of domicillary which would be the State of Florida.

Q I believe I asked you earlier, I'm not sure I've distinguished the two reports, was any exception made by any of the examiners who reviewed your business in this examination to the method of maintaining reserve?

A On the reinsurance. No, I read over this starting to page 16 and there is nothing contradictory to anything we have done on our reinsurance. It begins on page 16 and goes, I believe through part of 19—

MR. LANDON: The Plaintiff has no further questions.

THE COURT: Mr. Schwarz.

MR. GROSSMAN: Your Honor, I have a few questions to ask Mr. Floyd, but they're in the nature of direct examination but my understanding is that the witness would like to leave after his testimony, is that correct?

THE WITNESS: If possible.

MR. GROSSMAN: If there's no objection to it, it won't take very long and I'd like to ask some on direct.

THE COURT: All right, he's testifying as government's witness.

[233] MR. MASINTER: Do I understand the government wants to take Mr. Floyd as their own?

THE COURT: He'll make him his own.

MR. GROSSMAN: Yes.

CROSS EXAMINATION

BY MR. GROSSMAN:

Q Mr. Floyd, were you with the American Bankers at the time the 1957 contract was entered into?

A Yes sir.

Q And I take it you were also there at the time that the addendum was entered into in May of 1958, is that correct?

A Yes sir.

Q Now sir, at that time I believe they—a prior witness had indicated that the loss ratio on the accident and health policies that had been in effect approximately 11 months when the addendum had been entered into, had run about 30 percent. Was that your understanding too, or your recollection as to what the loss ratios were at that time?

A I have not checked the loss ratios on our statements going back to that period of time, but that would be very close and very reasonable. Yes.

Q I see, so at the point at which the addendum was entered into, which you agree was in May of 1958 and [234] approximately 11 months after the contract was originally entered into, there was a considerable balance of earned premiums, was there not, over the losses that had been incurred at that time?

A I would have to look at the statement to see—

MR. MASINTER: Your Honor, it seems—

THE COURT: Excuse me, go ahead, Mr. Masinter.

MR. MASINTER: It seems to me that having made Mr. Floyd his own witness, it would be appropriate to ask questions in a manner that would not lead the witness or call for conclusions based on questions stated and I'm not sure that I fully understand the scope of this inquiry.

THE COURT: Well, Mr. Masinter, I would think this as to the leading part and that, that by virtue I would be constrained to accept this man's qualification as an adverse witness in view of his employment by American Bankers and their tie to the Plaintiff per the insurance treaty, so I don't believe I'd be inclined to make him treat him as an unrelated witness in chief. Proceed.

THE WITNESS: Could we have the question again?

(Playback of question)

THE COURT: All right.

A I don't know the answer unless I would see [235] the particular statement which you are talking about. Then I could tell you exactly the facts on it. Going back that many years, I do not remember the earned premiums nor do I remember the losses paid at that particular time.

THE COURT: I thought you affirmed, though, that the loss experience was about 30 percent.

THE WITNESS: It should run about 30 percent on the disability.

THE COURT: Isn't that all he's talking about. Isn't profitability just another way of saying well, the loss experience was only approximately 30 percent or maybe I don't understand what he's—

THE WITNESS: It should generate about a 30 percent ratio.

BY MR. GROSSMAN: (Resuming)

Q I see, so would it follow then that if the loss ratio were about 30 percent, that there would have been a balance built up of earned premiums of—at the time the addendum had been entered into?

A I can't honestly answer that question.

Q Well, isn't that what the balance of earned premiums would depend on?

A —without looking at the figures themselves. I had charge of those figures being prepared. Now, if you can show me the statement, I'd be very happy to look [236] at it and tell you.

Q Well, sir, what would the extent of the balance of earned premiums depend on other than the loss ratio that had been incurred in prior months?

A The loss ratio has nothing to do with the earned premiums. The earned premiums are your beginning unearned premium plus your written premiums less your unearned premiums at the end of the month and the difference is your earned premium for that period.

Q Now sir, if I understand the prior testimony there was some temporary limitation on the amount of losses

that would be paid by Consumers dependent on the balance of prior earned premiums over prior losses incurred.

Now, were you in the Courtroom when there was testimony to that effect?

A Yes, I believe so.

Q Now, was there any other factor that entered into the question of what that limitation was as to the payment of losses other than the two factors of prior earned premiums and prior losses incurred?

A Not to my knowledge.

Q Now sir, would it then follow that the losses incurred in the past were minimal, that is a loss ratio of a small amount versus a large amount, that there would be a considerable balance of built up of earned premiums [237] over those losses which in effect would tend to minimize or negate the limitation on losses that would be paid by Consumers.

A If the earned premium exceeded the losses paid for that premium, we would make the payment to Consumers, yes.

MR. GROSSMAN: Could you repeat that?

(Playback of answer)

BY MR. GROSSMAN: (Resuming)

Q It goes to whether the limitation on Consumers liability to pay losses would in effect be minimized if there were a considerable prior balance of earned premiums over losses incurred? Do you understand that question?

A No, I don't.

THE COURT: I don't think the witness knows what you're talking about and I would suggest that you show him Article I of the Plaintiff's 2 if you want to pursue this so he does know what you're talking about.

MR. GROSSMAN: Your Honor, I think the factual answers that we've already gotten are sufficient to lay the foundation for whatever arguments would be made on brief and I won't pursue this any further with the witness. I have no further questions.

THE COURT: Well, I'm not trying to cut you off, [238] but it's clear to me he doesn't understand what you're talking about. Mr. Floyd, in the so-called 1957

agreement, the one that was modified in May of '58, there are two clauses and you may recall them earlier referring to, —

THE WITNESS: Yes.

THE COURT: —having to do with Consumers' liability as the reinsurer to reimburse American Bankers for the losses paid. The first was clause or rather, Article V, you heard them speak about. Then they got into Article I in the same indenture and this Article I had language in it, seeming to limit the clause V liability of Consumers to premiums earned, I believe it said, or to be earned by Consumers and I gather what he was talking to you about was under that Article I limitation, if the limit just be premiums earned or to be earned and the Consumers' reinsuring loss experience had earlier in the arrangement been so favorable that they built up a cushion in these premiums that they'd received but not had to pay out to reimburse American Bankers, would the limitation imposed by the ceiling amount of premiums earned or to be earned by Consumers be less stringent than it would have been, for example, had there been no prior favorable experience or had the prior experience been adverse. In which event you would not have had this cushion, that's what I was talking about.

[239] THE WITNESS: Well, yes, in other words, if they had earned a great deal of premiums and had low losses, we would have paid them some—or ceded them some monies.

THE COURT: All right, and the only thing that we know about is in point of fact, your affirmance that the prior experience up to that point yielded approximately a 30 percent loss ratio.

THE WITNESS: That is correct.

THE COURT: All right, anything further?

MR. GROSSMAN: No, that's all, Your Honor.

THE COURT: Mr. Masinter, now in that connection do you have anything of this witness?

MR. MASINTER: Nothing, Your Honor.

THE COURT: Thank you, sir, you may be excused. Off the record.

(Discussion off the record)

THE COURT: There being presently marked for identification Plaintiff's Exhibit 1 through 26, as I understand it, is there an offer, Mr. Masinter, with respect to those exhibits?

MR. MASINTER: At this time, Your Honor, we would like to offer in evidence Plaintiff's Exhibits 1—I think we ought to separate them, Your Honor, 1 through 19 as documentary evidence and Plaintiff's [240] Exhibits 20 through 26 as the illustrations of the expert witness' testimony.

THE COURT: All right, it's understood then that Plaintiff's 1 through 19 are offered as proof of the truth of their content and Plaintiff's 20 through 26 are consistent with counsel's earlier statement offered merely as illustrative of the Eddy testimony for those purposes. Is there objection?

MR. SCHWARZ: No objection.

THE COURT: Without objection, they will be received.

(Whereupon, Plaintiff's Exhibits 1 through 26 were received.)

THE COURT: Anything further for today?

MR. MASINTER: Nothing further, Your Honor.

THE COURT: Very well, we'll recess and then reconvene at 9:00 a.m. tomorrow.

(Whereupon, at 5:40 p.m. the Court recessed)

[267] • • • •

THE REPORTER: Would you state your name and address for the record, please?

THE WITNESS: Hubert, H-u-b-e-r-t, B. Sturtevant, S-t-u-r-t-e-v-a-n-t.

THE REPORTER: And your address, please.

THE WITNESS: 505 Wimbleton Road, Northeast Atlanta.

HUBERT B. STURTEVANT, a witness produced on behalf of the Defendant, having first been duly sworn, by said trial judge, was examined, and in answer to interrogatories, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARZ:

Q Mr. Sturtevant, what is your present position, please?

A I'm senior actuary, and chief examiner of the Georgia Insurance Department.

Q How long have you held that position?

A A little over ten years.

Q Would you state for the Court your responsibilities in that position, please?

[268] A As senior actuary I am responsible for examining, and auditing the companies financial statements, determining the validity of the formulas under which they compute their premiums, and non-prohibitive values in their policies, and any number of other things which arise in the—in the department's administration, and work with companies.

Q By annual statements are you referring to the annual statement blank which companies are required to file?

A Yes, I am, the NAIC blank, which all departments use.

Q By NAIC what are you referring to?

A National Association of Insurance Commissioners.

Q As part of that responsibility are you required to apply the insurance law of the State of Georgia with respect to a company's reserve requirements?

A Yes.

Q And, do you have occasions to determine whether a company should or should not set up a—an unearned premium or life insurance reserve with respect to particular kinds of insurance treaties that it has?

A Yes, that is one of my responsibilities.

Q What is your educational background?

A I was educated at the University of Michigan, in actuarial science, by the late James W. Glubar (pho-

netics) [269] And, upon my graduation in 1917, I became actuary of North American Life Insurance Company of Minneapolis, Minnesota. From there I went to the Iowan Insurance Department as an examiner, then to the Equitable Life of Washington, D.C., as assistant actuary, and finally for the subsequent 35 years to the Old Line Insurance Company of America, in Milwaukee, as chief actuary.

Q I see. And, in the course of that experience did you have occasion to prepare annual statements—prepare and examine annual statements?

A I did. I have prepared annual statements for both of the insurance companies—all three of the insurance companies that I worked for.

Q Did this require your understanding of the insurance requirements of a number of different states?

A Yes, it did.

Q Can you tell us approximately how many states whose insurance law you were required to understand and apply in connection with these annual statements?

A The largest number was with the Old Line Life Insurance Company of America. We were at that time entered in either 17 or 18 states.

Q And, in total could you give us some estimate of the number of different states whose laws you have familiarized yourself with in connection with your work [270] over your career?

A Well, as chief examiner for the Georgia Insurance Department, I have had to examine the laws—portions of the laws of—oh, I would say 40 states.

Q Have you ever served professionally on—on committees or any associations dealing with insurance?

A Yes, I'm presently a member of the Life and Accident and Health Sub-Committee of the Blanks Committee of the National Association of Insurance Commissioners.

Q What is the responsibility of that sub-committee?

A Ah—we have regular meetings at which we discuss recommendations that are made by industry, and by various regulators in the form of the statement blanks that are presented each year.

Q And, what kind of recommendations does the committee make with regard to these statement blanks?

A Ah—recommendations—these I might say, that these blanks after they are accepted by the insurance department become public documents, and—

Q Could you explain what a blank is in case the Court is not familiar?

A Well, that's—it's a large size book, which contains the balance sheet of the company, the—ah—schedules of—of investments, and their report on the operations in all of the—each of the states in which they [271] are licensed, as far as premium receipts, and so forth are concerned, the claims.

It gives a very comprehensive picture of the company's economic progress, particularly.

Q Are these blanks the—the uncompleted forms which in their completed form were introduced into evidence as the annual statement forms of Consumer Life Insurance, as Plaintiff's Exhibit number 9?

A I assume that they are, I didn't see the Exhibit, but I understood that that was what they were.

Q And, is that form the basis upon which an insurance department evaluates the activities of an—of a company?

A Well, that's the—that's the form in which they keep in yearly touch with the activities. Of course, when they make an examination then they verify the correctness of the statements which have been filed in the intervening time since the previous examination.

Q Mr. Sturtevant, which insurance companies—what connection does an insurance company have to have with the State of Georgia in order to bring it within the responsibility of the Georgia Insurance Law, and within the responsibility of your department to evaluate its financial affairs?

A Well, according to the Code, the Commissioner is [272] charged with the responsibility of—of certifying that a company is in compliance with the laws, that it is financially able to take care of its policy obligations.

Q Does the Georgia Insurance Department have jurisdiction over all insurance companies which are—which are domiciled in—in Georgia?

A It certainly does, and also all companies which are licensed, foreign and alien companies.

Q I see. And, if a company does business in Georgia, but it is domiciled elsewhere—is incorporated elsewhere, would the Georgia Insurance Department have jurisdiction over it as well?

A Definitely.

Q All right. If a company's annual statements have been examined by—if a company is domiciled in another state, and its annual statements have been examined by that state, but the company does do a substantial amount of business in Georgia, would your department consider that it has a responsibility to evaluate the financial affairs of that company?

A Yes, it does.

Q And, to determine whether the annual statement blank comports with its rules?

A Yes.

Q Does Georgia generally defer to the evaluations [273] made by another state in which the company is domiciled?

A We accept the home state's certificate, of the correctness of the policy evaluations, the existance of any required deposits, statutory deposits, I guess that's about it. Each state is supposed to be responsible for the valuation of its companies' policies.

Q Are there some general provisions of state law which permit two different policies with regard to its implementation, both of which may be correct?

A No, while we do in judging the—ah—the legality of a company's investments for example, a foreign company's investments, we will naturally lean as far as we can towards the—what the home state permits. However, if—if they go so far as to—to enable the foreign company to do something which a domestic company is not able to do, then we—that's where we draw the line.

Q I see. Can you tell us Mr. Sturtevant, what the primary purpose of an unearned premium reserve is?

A The primary purpose of an unearned premium reserve is to insure that the company carrying the reserve will have the financial ability to pay claims when and if they occur.

Q I see. Can you describe the unearned premium reserve requirements,—the requirements of law in the [274] State of Georgia?

A Georgia has a requirement as far as accident and health insurance is concerned, that the minimum of reserves shall be the pro rata unearned premium.

Q Is that the gross unearned premium?

A We so interpret it.

Q Doesn't the statute expressly state that the gross unearned premium—

A I'm not sure, about that, whether it does or not.

THE COURT: Excuse me, now, what statute—the Georgia statute?

MR. SCHWARZ: Yes, that's what I was referring to.

THE COURT: Can you identify that, or—

MR. SCHWARZ: I don't have the citation with me, Your Honor. We could perhaps get it by the end of the day.

THE WITNESS: It's—title 56, of the Georgia Insurance Code, effective January 1st, 1961.

BY MR. SCHWARZ: (Resuming)

Q Is there anything in the Georgia statute, Mr. Sturtevant as opposed to any regulations or policies that the insurance department might have which expressly states which of two companies, a ceding company or a reinsurer shall [275] reflect in unearned premium reserve on its books, under any kind of reinsurance treaty?

A Ah—I can't exactly quote the section entitled standard valuation, but this states that the basis on which the net premium is computed,—minimum net premium is computed, and it states that the company shall carry the reserves computed on that basis as a liability.

Q Is this a life insurance reserve that you are referring to?

I—it may be—it may be confined to life insurance, I'm not sure whether it is general or not.

THE COURT: Again, this is a statutory provision that you are referring to—

THE WITNESS: Yes, sir.

THE COURT: Of Georgia law?

THE WITNESS: Right. This I might say is—a pretty standard provision, which has been adopted by nearly all the states.

MR. SCHWARZ: Your Honor, we will refer specifically to the law in our brief, I'm not sure that we have clarified the subject on these several questions.

BY MR. SCHWARZ: (Resuming)

Q Have you had occasion in your experience, Mr. Sturtevant to examine reinsurance agreements?

A Yes, I have examined a good many.

[276] Q Is it fair to say in a typical reinsurance agreement, a portion or all of the insurance company's liability is reinsured with another company, that it pays over the reinsurance premium to the reinsurer at the outset of that coverage?

A Well,—

Q I'm not referring to credit, accident and health insurance at the moment, but reinsurance in general?

A Um-huh—Well,—

MR. MASINTER: If Your Honor, please I would like to object to the way that counsel is asking these questions, because I think that it would be appropriate for the witness to tell us what his interpretation of these contracts would be not for counsel to suggest to the witness what they are, and whether he agrees or disagrees, that is an easy way to do an expert, and he has already indicated that he doesn't know what the statute is, and he has already indicated he is not sure whether it applies to life or A&H, and I'm not sure what this witness does know, so I would like to hear from him rather than from counsel.

THE COURT: Restate the question.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, in a typical reinsurance arrange-
[277] ment, can you tell us whether the premium—the reinsurance premium is payable to the reinsurer for the entire term at the outset, or is it paid on some other deferred basis?

A By typical reinsurance agreement, I assume that you mean that the one that I see most frequently. I would say that of all the reinsurance agreements which I have studied, all those which relate to—

Q Excuse me, I would like to withdraw this question, and approach it in a different manner, if I may Your Honor.

Mr. Sturtevant, are you familiar with the examiner's handbook of the NAIC?

A Yes, I am.

Q Could you tell the Court what that is please?

A It's a series of directions and—ah—references to various parts of the—of the regulations which have been laid down from time to time by the National Association of Commissioners, and it is prepared for the use of directors when they are making examinations, and has been prepared in the interest of uniform getting uniform examination reports.

Q You said prepared for the use of directors, could you explain that?

A I'm sorry, I meant to say examiners.

[278] Q Would you say who these examiners are, and how these directions relate to their work and to the statutes of the individual states, which set forth the insurance law of those states?

A Well, each state retains examiners, on one basis or another. Most states employ examiners on the state payrolls.

In the case of Georgia, we do our examinations by contract. In either case, the examiners are accountable directly to the chief examiner of the state for which they are—under which they get their directions to make the examination.

These examiners in the case of Georgia are men with great experience, and have been employed by the person with whom we contract because of their examining ability.

Q Are these examiners required to apply the Georgia insurance law and code, and the department's regulations?

A Yes, they are.

Q And, your office has ultimate responsibility to determine the correctness of that—of that application?

A Right.

Q Then, how does the handbook serve these examiners in the conduct of their examinations?

[279] A Ah—in the course of the examination they would be assigned to different phases of the work, accounting, judging assets, securities, and so forth, and such things as treatment of policy holders, compliance with the law, and drafting of policy plans and so forth.

The examiner—the Georgia examiner is supplied with the copy of the Georgia Insurance Code, and with a copy of the National Association Insurance Commissioner's Handbook, and he is supposed to follow the outlines in the handbook, which relate to the particular part of the job that he is on.

Q Are the insurance laws of the various states fairly uniform with respect to unearned premium reserve requirements?

A Yes, they are.

Q And, does the handbook tend to supply some specific direction to the examiners with regard to the examination of not only those reserves but other assets of the company's business, where the laws are uniform on a particular subject throughout the country?

A Yes.

Q I see. Is that what you meant when you said the handbook tries to achieve uniformity?

A Right.

MR. MASINTER: Can I hear that question again, [280] please?

(Whereupon, the Reporter played back the question.)

MR. SCHWARTZ: I would like to mark this document for identification as Defendant's Exhibit 7.

THE REPORTER: Defendant's Exhibit number 7 marked for identification.

(Pause.)

MR. MASINTER: If Your Honor please, at this time we will object to the admissibility of this handbook.

I know that it hasn't been offered as yet, but I imagine that it will be, and that if the purpose of identifying it is for the offering it into evidence, then we would object to it. It is not law, and doesn't have the effect of laws, and as according to the witness's own testimony merely a guidebook for the application of various states' regulations.

And, to my information as yet, this handbook has not been tied to any relevant material in this case. And, in fact, I don't think that it can be.

THE COURT: Well, hadn't we better wait until we hear the purpose for which it is going to be offered if at all?

MR. MASINTER: I expected that would come, but I would like to note my objection at this point. [281] So that the Court will be aware that I—that we do object to the admissibility of this handbook.

THE COURT: Well, as I say I think—my view of it would depend very largely on the purpose for which it is going to be offered, if offered, so let's see what that proves to be.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, will you identify the document please?

A Yes, this is the handbook to which I referred.

Q Describe for us the parts into which the handbook is divided?

MR. MASINTER: I didn't hear you.

BY MR. SCHWARZ: (Resuming)

Q Would you describe for us the parts into which the handbook is divided?

A It is divided into ten sections that those—ah, those relating to examinations; section 2 procedural following examinations—

Q Excuse me one moment, please. Before referring to the number of sections, there are several parts to the handbook, the sections you are—

A Um-huh.

Q Referring to are sub-sections of part A, will the parts into which the handbook is divided first?

[282] A There is part A, which is the manual of the association examination, practice and procedure, second edition, 1951 revised, and the third edition, 1970 revised. B,

Q Part B?

A Part B, is reinsurance sub-committee reports as amended.

Part C, is instructions for uniform classifications of expenses of fire, marine, casualty insurity insurers, interpretation of uniform accounting instructions.

Part D, examination of accounts and records compiled by electronic computers.

Q Turning to part A, Mr. Sturtevant, can you tell us what the purpose of this part is, and what relevance that it has to examination of annual statement forms under Georgia law and laws of other states?

A Well, under the general heading of practice and procedure, it instructs the examiners how to perform their duties as examiners, how to write the report, the form that it will take, the method of—of authorizing the examinations, and the examiners appointed to take part in it. The manner of inviting other states than the homestate to participate in the examination. All of the practical aspects of the actual physical work of the examining.

[283] Q Does the Georgia Insurance Department adhere to the requirements and statements set forth in this part?

A Yes, it does.

THE COURT: Did you give a date for this, Mr. Schwarz, this publication?

BY MR. SCHWARZ: (Resuming)

Q Would you give a date, Mr. Sturtevant?

A Ah—this is—ah—gives reference to the 1961 NAIC proceedings, Volume I, pages 123 to 125. Let's see that is part A.

Part B, the same reference, page 147 to 177. Part C, the same reference, pages 179 to 282. Part D, reference to 1963 proceedings, Volume II, pages 524 to 533, and 1964 proceedings Volume II, pages 361 to 365 inclusive.

Q What are these NAIC proceedings to which you referred, Mr. Sturtevant?

A They are the record of the annual and semi-annual meetings of the society which are held regularly, they are national meetings. And, it—they also contain transcripts of the reports of all sub-committees, and parent committees, to the executive committee.

Q Would you turn to part B, now, and tell us what is generally covered in part B, and again how the [284] substance of part B is related to the law, and the insurance requirements of the State of Georgia?

A Ah—Well, part B, index A, refers to abstruse, complicated contracts, various types of contracts, allowances of credit and so on and so forth.

Q Before going into the specifics, would you describe the—how the general subject of this part B?

A Reinsurance sub-committee reports.

Q Does the report then relate to reinsurance?

A It does. Reinsurance sub-committee reports. This is a sub-committee—a standing sub-committee of the National Association of Insurance Commissioners. It covers various types of reinsurance, commissions on reinsurance, contracts providing sliding scales, credit allowance, and credit against gross premiums, and unearned premium reserves, the kind of reinsurance contracts, and credit allowance, and the reinsurance is redetermined here in short notice.

Q Excuse me for interrupting you, the item you just read, credits against gross premiums, and unearned premium reserve on account of reinsurance ceded—

A Um-huh

Q How does the discussion of that topic in the manual relate to Georgia law, and to the law of other states, and to the application of that law in the conduct [285] of examinations?

A Ah—a—ah—a direct writing company—

Q I don't want you to go into details as to exactly what the report says, but when somone is conducting an examination, what relevance is there to what the report says as a general matter to what he is supposed to do in his responsibility in carrying out the law of the particular state?

A I see, well, the first thing he is supposed to do is to read the various types of reinsurance contracts, and see that—what the terms are, and whether they render the reserves the company carries under those contracts or that the reinsurer carries for that company under the contract, is allowable as a credit against the total reserve liability of the insurer.

Q Does that phase of the—of part B describe principals which he is supposed to apply in that examination?

A Ah—it—I would say rather that it prescribes what he should look for, and what he should report to the Commissioner on—as unusual, or possibly something which would not permit the—the allowance of the reserve deduction.

Q Now, the subjects that are referred to, does he look to these for—an indication of what to look for, [286] because the state law itself and regulations are not specific with respect to these items, that is they don't state all of the items that are to be looked for?

A I think that that is generally true.

Q Now, we turn to part C of the agreement, and state for us briefly what the relevance of part C to an examiner in any state in the country in the conduct of his examination?

A Um-huh—well, this is instructions for uniform classification of expenses, and interpretations of uniform accounting instructions.

Q And, does Georgia law require that these instructions be followed in the conduct of examinations?

A They—the Commissioner requires that, not by law, but—

Q What power does he have to require that?

A He has his discretionary power, and his power—a power which is invested in him to examine conditional companies which are licensed in the state.

Q And, is that true in other states as well?

A Yes.

Q Thank you.

THE COURT: Mr. Sturtevant, when you retain one of these investigative contractors to which you referred earlier, is he given one of the publications represented [287] by Defendant's 7 before you?

THE WITNESS: Yes, he is.

THE COURT: And, in the ordinary course, is he told that this is to be his procedural guide for the conduct of the work for which he has been retained?

THE WITNESS: Yes.

THE COURT: I see.

MR. SCHWARZ: I offer Defendant's Exhibit 7, into evidence, Your Honor.

THE COURT: Well, now, for what purpose?

MR. SCHWARZ: For the purpose of setting forth the procedures that are to be followed, and for proving the principals that are stated herein for the use by these examiners in the conduct of their examinations, that is the manual sets forth certain principles, enunciated by the NAIC, which are to be followed. We offer the document to prove what those principles are.

THE COURT: Well, specifically, Mr. Schwarz are you or you not offering this to prove for example what Georgia law is with respect to any particular point, or are you simply offering it to prove the—ah—practices and procedures employed by the Georgia regulatory authorities?

MR. SCHWARZ: Our primary emphasis is in proving the practices and procedures of the authorities [288] but to the extent that the principles stated herein are applicable by the examiners, in interpreting the general provisions of Georgia law, and the law of other states. It is being offered as a basis for that law. We are not trying to prove Georgia law with regard to a particular matter. But, we are trying to prove certain principles which are applicable in all the states in the interpretation of their law.

THE COURT: Mr. Masinter?

MR. MASINTER: That's the point to which I would like to object again, Your Honor.

THE COURT: Well, all right, let's see if we can—by a process of elimination clear the air a little bit. Do you have any objection to it as proof of what I have referred to as investigative practices and procedures, and the like for the conduct of—of examination by the Georgia authorities?

MR. MASINTER: Yes, sir, I do.

THE COURT: All right, now why?

MR. MASINTER: For the simple—I object to it entirely on any ground whatsoever for the following reasons.

First of all, it does not apply to the years in question. As I understand it, these are the proceedings of various parts that are written up, and reflecting pro-
[289] ceedings that took place during the years in question, 1961 through 1964. I don't know when the handbook was published, but presumably it occurred after the tax years in question. There is no evidence that the examination of the Plaintiff's annual statement or report in those years were conducted on the basis of that report.

Now,—

THE COURT: Well, all right. Now, on that then, how about taking some voir dire on that, because I assumed that when I asked for a date of the publication and I was told—I acknowledge that it was referred to in conjunction with some proceedings, but 1961, I thought that they were telling me that that was the date of the—of the publication. But, take a voir dire on that, let's tie the chronological relevance matter down, one way or the other.

MR. MASINTER: All right. Well, I could at the same time tie down some other points that I have some questions about.

THE COURT: All right, why don't you just take him on voir dire here?

MR. MASINTER: With respect only to the—to the NAIC report?

THE COURT: Yes.

MR. MASINTER: All right, sir.

[290] VOIR DIRE EXAMINATION

BY MR. MASINTER:

Q Mr. Sturtevant, are you familiar with the date of publication of this report?

A Ah—no, I assume though, that it was published in connection with the—with a resolution which was adopted by the NAIC.

Q When was that resolution adopted?

A Well, it refers to the 1961 NAIC proceedings, which would be the proceedings—of Volume I, which would be the transcript of the—of all of the proceedings of the meeting held either on June—the first week in June, or the first week in December of 1961.

Q Now, that was part A only, as I understood you?

A This was part—well, it was part A, B, and C.

Q Parts A, B, and C?

A D was in 1963.

Q 1963. When was this handbook made available to the examiners?

A Ah—it—I can only say for my own experience, which stems from 1963, it was in existence, and in the examiners' hands when I came with the department in 1963.

Q But, at least it would not have been prior to 1961, but in any event you know for a fact that it was [291] available in 1963?

A Right.

Q And, any examination of insurance companies would have been based upon the principles enunciated in that handbook commencing in 1963?

A Yes. Now—ah—you know—is it necessary—

THE COURT: Well, that's all right, go ahead.

THE WITNESS: I was simply going to add that this—the handbook as we have it today is as amended as time went on.

BY MR. MASINTER: (Resuming)

Q In other words the one in front of you today, is as amended since 1963?

A Right.

Q Can you point out those amendments?

A Ah—here's one. Effective January 1st, 1972, to amend the per diem compensation and allowance to be subject to the Federal Wage and Price Guide, and things of that sort.

Q How are the amendments noted?
A By a footnote.
Q So that one is able to—
A On the page—the effective—
Q One is able to tell chronologically when the [292] amendments were added and the effect of it. You mentioned that this handbook applies to insurance, what type of insurance?
A All types.
Q All types. But you said it applied to fire and marine casualty, didn't you?
A One section—I think that it was B—ah—C. C is in two sections, the first one being instructions for uniform classification of expenses of fire, and marine casualty surety insurance, all insurers except life, and title.
Q Could you show us in that handbook where it says it applies to all types?
A Ah—yes. This is manual of association examination practice and procedures, part A. This says second edition, 1951, revised. This is a date prior to what we have here in these references.
THE COURT: Mr. Masinter, has the Government furnished you a copy of this?
MR. MASINTER: No, sir. But I have a partial copy, in my own files.
THE COURT: Do you have a copy to furnish him, Mr. Schwarz?
MR. SCHWARZ: I don't have—I can have one made and send it to him. I can use the extra copy that I [293] have for myself.
THE COURT: Well, at least let him do that now—
MR. SCHWARZ: Certainly.
THE COURT: I—the, really I think you should appreciate his attitude about this, because I don't understand offering a document that you haven't given the other side.
MR. SCHWARZ: It was through inadvertence. It was a public document that was referred to in the Penn Security case, and it was—our reliance upon it has been rather open, and for some time—

THE COURT: Well, I didn't mean that you were trying to waylay him, but standard practice would be—to indicate when you stand up and offer any exhibit, that you had given the other side a copy of it, that's all that I mean.
MR. LANDON: It may have been introduced in Penn Security, but I am not sure that it was ever referred to in the decision.
MR. SCHWARZ: Your Honor, if I may ask—interrupt the voir dire to ask one or two questions on—to the witness on the—on the timing of the document. There are things that I have just found in there which I think may satisfy Mr. Masinter somewhat, and perhaps [294] form the basis for a further voir dire on his part.
THE COURT: Well, excuse me, let's—now, wait a minute, let's have a ten minute recess, and you—and counsel can consult, and then resume with this, and see what—

(Whereupon, at 10:24 a.m., the hearing in the above was recessed as described above.)

THE COURT: Resume the stand, Mr. Sturtevant.
MR. MASINTER: Your Honor, could I please go back to the last question that I posed—
THE COURT: Yes.
MR. MASINTER: I think that I asked him about, where does it refer, he said all types, and I asked him if he could show us where, I think that that was what the question was.
THE COURT: I believe that that was it in substance, so that's all right.
THE WITNESS: This does not specifically refer to any type of insurance—it generally covers any type, except it has one case where they introduce some special instructions with regard to—the schedule—part C, instructions for uniform classifications of expenses, fire, marine, casualty, surety insurance. In the annual statements in accounting procedures which casualty companies are required to keep, they allocate expenses, claims and [295] so forth to explain the insurance covered.

BY MR. MASINTER: (Resuming)

Q Is accident and health insurance, fire and marine casualty insurance?

A A casualty company may issue, and many do accident and health insurance.

Q I see. Well, would you consider Consumer Life Insurance Company a fire and marine casualty—

A No, that—by their name itself, they are a life insurance company, and under Georgia law a Class I company is entitled to—to issue and accident and sickness.

Q I see, but this handbook refers to fire and marine casualty companies?

A That's right.

Q I'm not sure that—that I fully understand. You tell me that it applies to all types of insurance, but that it specifically refers to fire and marine casualty insurance, and it is possible for a fire and marine casualty insurance company to write accident and health insurance, but that's—and so, by your impression, that accident and health insurance would be included is that correct?

A Ah—

MR. SCHWARZ: Your Honor, I think that the manual refers to casualty insurers as a separate type of [296] insurer, and not to fire and marine insurers, casualty is a definition of fire and marine.

MR. MASINTER: I'm not asking—

THE COURT: Do—do you understand the question, Mr. Sturtevant?

THE WITNESS: The question that he put to me, I think that I understand—

THE COURT: All right, fine.

THE WITNESS: In that he expects that there will be classifications of various types of insurance.

BY MR. MASINTER: (Resuming)

Q Where does it say in the book that this book applies to accident and health insurance?

A Ah—only—well, for example, let's see here's life in section 11 of part A—

Q Part A?

A Yes., it refers to life reinsurance. This is only—I don't find any—special—

MR. SCHWARZ: On page 82, Your Honor, of the—

MR. MASINTER: I think the witness as I understand it, he is the one that is supposed to be qualified to tell us what the book is about, either he knows or he doesn't.

MR. GROSSMAN: Well, I suggest that the book itself indicates what it is about to a certain extent, and I think [297] that counsel are qualified to point the pages in the book, which will help the witness refresh his recollection about the contents of the—

THE WITNESS: Here is a—I see a reference here to—ah—dividends to participating life annuity and health policy holders and contractors.

MR. MASINTER: That doesn't relate to reinsurance.

MR. SCHWARZ: Your Honor, I would like to refer to page 82 of the manual, where I think it's specifically—it is stated that life companies are covered by this procedure, and it is in the second paragraph, page 82.

THE COURT: Well, I thought he was asking about accident and health.

MR. SCHWARZ: Well, I gather that we are trying to determine whether the policies at issue are covered by this manual, and it seems to me that we ought to go right to it, instead of—

MR. MASINTER: I asked the witness if the manual applies, and if he can point out where the manual says that it applies to accident and health insurance.

THE WITNESS: It applies to all—all insurers,—examination of all insurers.

BY MR. MASINTER: (Resuming)

[298] Q Where does it state that in the book?

A Ah—it says in the foreword, in this manual incorporated for convenient reference, the rules and regulations and procedures relating to association examinations as adopted by the National Association of Insurance Commissioners, such amendment—let's see, the third edition incorporates all amendments adopted by the

NAIC, up to and including December, 1969 meeting. Such amendments include original procedures for guide for examinations, which are necessitated by substantially amended annual statement forms adopted for fire and casualty companies in 1950, and for life companies in 1951.

So, they—they are covering the whole thing,—

Q But you still haven't pointed out where the specific paragraphs that you were talking about—

A By reference.

Q Applies to accident and health. You have told me that it applies to casualty, fire and marine, and life.

A Ah—in the section relating to—

MR. SCHWARZ: We haven't attempted to prove that any particular paragraph is relevant here.

THE COURT: One at a time now, this transcript will be unintelligible if you interrupt.

THE WITNESS: In the reference relating to casualty—or to credits against reserves, I believe that [299] they speak of accident and health—let's see.

Q Well, that's exatly what we are trying to find,—if the book does speak about it—about accident and health, then if you could point to it, we would appreciate it.

MR. GROSSMAN: Well, Your Honor, I have a reference here, to page A-19, in which it says group life and health insurance policies, group annuity contracts, and individual health insurance policies, and I think interspersed throughout the book are references to different kinds of policies, including accident and health policies. And, there are also references to—as has pointed out, to life companies, which this company was. I don't think that there is any problem of going through the book, and —and finding the particular references. We certainly don't offer this document for anything that it doesn't purport to be, or what the witness has claimed that it purports to be.

THE COURT: Well, I suggest that the approach that you are recommending here could have been better achieved had you furnished the other side with a copy of your proposed exhibit before you offered it.

Have you gotten any clarification on this chronology matter, which is what I thought was pending when we recessed?

[300] MR. MASINTER: I think that we have, Your Honor. There is a table that sets forth the kind, as to the proceedings. It is not clear to me that this book was made available to the examiners or was in fact even published. I don't even know if that is true or not, Your Honor.

I have one further question.

BY MR. MASINTER: (Resuming)

Q Do I understand that this—this correct, that this book is not considered as law in the state of Georgia?

A No, it is not considered law.

Q How about regulation, is it considered as a regulation?

A Ah—there is no formal regulation—

Q No formal regulation. Do you publish informal regulations?

A No, we only—

Q Is there such a thing as an informal regulation?

A Ah—yes, the Commissioner would tell—would require the examiner to use this—this examiners' handbook, and to follow the procedures set down in there, and—

Q So, what you are saying that that is a departmental type of instruction to examiners?

A Right.

Q To use the handbook, but is that—is that [301] published anywhere in your regulations that the handbook controls?

A No, it isn't.

Q All right. Is there—well, I have no further questions.

THE COURT: All right, so now your objection is what Mr. Masinter?

MR. MASINTER: Ah—

THE COURT: In the light of the voir dire?

MR. MASINTER: I would object to the admissibility of this handbook, to the extent that first of all it has

not been established that it is relevant to the years—for the taxable years in question, and to the extent that it might be, I think it ought to be specifically pointed out, which years would be involved.

Second, I don't think that it has been established that this book applies in respect to which the witness has testified, to the type of insurance that we have involved in this case, namely reinsurance of accident and health insurers.

Thirdly, I don't think that it has been established at all that this book has the effect of law or regulation in it. In fact the testimony of the witness clearly is that it is not law or regulation, and I think that we are talking here about—in this case, reserves [302] required by law, and the guidebook, or handbook for insurance examiners to my way of thinking would certainly not serve as any evidence in this case of what might be required by law in the State of Georgia or in the State of Arizona or Florida.

THE COURT: All right. Mr. Schwarz, what about —for the moment, the chronology aspects of this, when was this thing—originated, when was it used according to you?

MR. SCHWARZ: Your Honor, I can't give you a specific date as to when the manual was published in this form, and issued to examiners in this form for the conduct of examinations. There are references in the book indicating when the NAIC promulgated the specific sections and information that is contained here.

THE COURT: You mean these proceeding references, 1961 that the witness—

MR. SCHWARZ: Not—that's the—that reference indicates, apparently, and I can't say this for sure, when all of these various sections were brought together in the form of this manual, but I am referring to the proceedings in which the various sections which were brought to the manual were originally promulgated as NAIC policy. These—there are sections within the manual which referred to that.

Under part A, page A-34, has a series of references [303] —I believe that it is page A-33, I think that I have an earlier copy, I'm not sure.

Page A-33 refers to references by edition, and that refers to editions of the manual, I assume, so I believe the manual has been issued earlier. The first edition as indicated to have been issued in 1958, and—1948, and under the heading of first edition, 1948, are a series of references to NAIC proceedings in prior years, from which the sections that were included in that first edition were taken. The years that are referred to are 1931 through 1948.

Then the second edition, first was published in 1951, and that refers to 1952 proceedings, which I assume must have been conducted in 1951, and so forth, up to—the third edition, which was published in 1970. So, there have been three editions, one in 1948, one in 1951, and the third edition in 1970. That's part A.

Part B, which is the part which we are primarily concerned with in this case, page B-31, again states a series of references to NAIC proceedings from which the substance—from which the details in part B come. Those proceedings run from 1949 through 1954. All of them well before the years in suit.

I think that in terms of years that the manual was issued prior to the years in suit, we can't ascertain [304] exactly which items were there, and which were not during the years in suit, however the reinsurance committee report was completely issued before the years in suit, and that is the one that we are concerned with.

THE COURT: All right, now, I take it, Mr. Schwarz, that you are not offering this Exhibit to prove either Georgia law or—well, let me amend that, you are not offering this Exhibit to prove any state law or any state regulation, is that correct?

MR. SCHWARZ: Yes.

THE COURT: All right. That being the case, and—ah—I think that that is well taken, because I don't see how it could be admitted for that purpose. If you were going to offer it simply to prove administrative practice

and procedure in Georgia with respect to the conduct of its carrier audits, I would admit it for that purpose, but for what to me is still an extremely murky chronology. That is to say, I hear these references to some proceedings and somebody's report, and something else, but when you get down to when the book came out, we seem to keep coming up short.

Now, beyond that it would appear to me that the witness that you have here in view of his—employment status and Georgia experience would be fully competent to testify to any matters of investigative practice and procedure [305] on the part of the Georgia people. For that—in the light of that practical consideration, I am constrained to sustain the objection on grounds on chronological relevance.

You are free to make an offer of proof with respect to this, in which you can have it available to you for any use that you can persuade the Court on appeal, might be proper.

But in the meanwhile, I am suggesting that it is not at all clear to me that this publication could furnish anything in the area of administrative practice and procedure that could not be obtained from this witness.

MR. SCHWARZ: Your Honor, a portion of the report—a portion of the manual, which we are primarily concerned is part B—

THE COURT: Right.

MR. SCHWARZ: The reinsurance sub-committee reports. I've mentioned that all of the NAIC proceedings from which that report was taken were published by 1954 or 1955, the first year in suit—

THE COURT: I understand that. I mean—I understood you to so state earlier. But I don't—to me, so they published their proceedings, but I don't—there is nothing in that paper that puts it in the hands of—of a [306] Georgia contract investigator in the ordinary course at the—well, say 1958—1959, 1960. In any event you—is there—if there is, I have overlooked something, but—

MR. SCHWARZ: The—the edition that we have offered is a third edition published in 1970. The second

edition of the manual was published in 1951. Now, we could probably get a copy of the second edition of the manual to offer into evidence on the basis of—of the years.

THE COURT: Well, I would suggest that you make your offer of proof, the ruling will stand, and proceed in that manner. You do use the witness as you wish, and make your offer of proof.

MR. SCHWARZ: All right.

(Pause.)

MR. SCHWARZ: Your Honor, we make an offer of proof that this NAIC manual, which was marked for identification as Defendant's Exhibit 7, and is excepted, to prove that the details of the examination procedures to be followed by examiners in the various states in the conduct of ordered examination. But also set forth certain principals enunciated by the NAIC to be followed by the examiners as a general matter in the conduct of those examinations. And, the details, examination procedure, the statement of accounts that—into which items were to be classified, and the statements of policy, all apply, [307] where they so state, or where the principles were stated generally to the kind of insurance that was involved in this case, and would apply in the conduct of the audit examination of both Consumer Life Insurance Company, and American Bankers.

THE COURT: Very well, we have the chief examiner for Georgia here, and it would seem to me that everything that you have mentioned is within his area of competence, at least so far as relevant here.

DIRECT EXAMINATION

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, I would like for you to refer to—I would like to refer you to several different topics discussed in the manual, and ask you to—to review them for us, and then state whether you agree or disagree

with those concepts, and how they relate to the conduct of examinations in the State of Georgia, and in the other states in which you have had experience.

Would you turn to page B-14, please?

MR. MASINTER: I'm not sure that I follow this line of examination. I'm not sure that it is proper to read from a book, and ask him if he agrees or disagrees, I think that you could ask him to discuss the question with the Court, and educate us as to the general principles involved, I would be delighted to hear that, but it is very [308] easy for me to read a paragraph, and say I agree or disagree.

THE COURT: Well, I don't know that whether—how he feels about it, en sympatico (phonetics) is—is particularly important, but I—I do think he could—his attention could be directed to a particular provision, and he could be asked in his capacity as chief examiner, Mr. Witness, is this whatever it may be applied routinely by your examining force here, and then he can give any explanation that he wants to. But, what he thinks about something I would be inclined to agree, I don't understand that.

MR. SCHWARZ: Well, I specifically am desirous of asking—of having him state a principal that is referred to here, and asking whether that is a principle which he follows in the conduct of his examinations, and whether it is his understanding that this is a general principle that is followed by the various states, and by examiners in the conduct of their examinations.

MR. MASINTER: Well, I am not sure that he can testify as to that and—

THE COURT: Well, I don't know. I mean, you—why are you unwilling to confine him to Georgia?

MR. SCHWARZ: Well, for one thing, the—we are not trying to ultimately prove Georgia law, or what the Georgia Insurance Department specifically would do in a [309] particular case. We believe that the Court needs to be apprised of principals of insurance law and accounting that are applied in the conduct of examinations generally.

And, we think that these principals apply not only in Georgia, but elsewhere. If the Court is to make a determination of the tax issue here, it must understand the concept of unearned premiums, and unearned premium reserves as it is used as a policy concept throughout—in the industry.

THE COURT: Well, but Mr. Schwarz, how is this man competent to tell us why the investigative practices of insurance people in New Hampshire are or New Mexico, or Idaho, I don't understand that?

MR. GROSSMAN: Your Honor, might I say that Plaintiff's principal witness, Mr. Eddy testified at length about general insurance principles and policies, and in particular on the NAIC interpretation of policies, and to the extent that his testimony was at all competent, this document is competent evidence, and ought to be admitted in the case, and particularly part B, which reflects NAIC policy as of a date before the items in issue arose.

Now, to the extent that part B of this document reflects NAIC policy, at least before 1955, it is as competent as Mr. Eddy's interpretation of what general insurance principles are, and NAIC policy was, and to the extent that [310] this document is not competent then all of Mr. Eddy's testimony is not competent.

THE COURT: Well, first of all, I don't—I don't find the—the reference to Eddy helpful. Eddy was here. He was available to be cross examined on the basis of his knowledge, and what have you. Now, I—I assume that when everyone said that they were through with him, they were satisfied that they had covered what they wanted to with him.

Now, if—my problem is in this context, this broad educational enterprise that you are embarked on here, that maybe helpful to the Court, maybe it is indispensable, but to the extent that you really feel that it is germane to—to know how this NAIC crowd feels about something as opposed to the relevant regulatory bodies in the—in the coverages that we are concerned with, then it just seems to me that—that you have the wrong pig by the ear here. There is no point in getting a man

from Georgia to tell you about this NAIC unless he has had some additional capacity, are you a functionary of this NAIC body, Mr. Sturtevant?

THE WITNESS: No, I am not, except to the extent of serving on committees.

THE COURT: Yeah, right.

MR. GROSSMAN: Your Honor, he is an expert, who —and also in the area in which he has been able to lay [311] the foundation for the document being a reflection of NAIC principles, something that is an official promulgation of the NAIC. And he has testified to that. Now, what the document says itself stands for what it says. We don't need the witness to verify that the NAIC said that any longer. He has already said that the document purports to be an official statement, of the NAIC.

And, that's all that we are offering the document for. Whatever—

THE COURT: But, you—just a moment, you are suggesting that it has pertinence apart from usage in this instance by Georgia investigators. And, what I am saying is that in that realm to the degree that you want this in as some kind of a general expression in the field, I don't think that you have the right witness to put it here. And, I am not impressed with—ah—I mean you talk about Eddy, and what he thought or some observations that he made about this NAIC, I can assure you that to the extent that that transcript reveals that his connection with those things were in any way similar to what this man acknowledges, why I'm not—maybe I ought to be impressed with that, but I don't plan to be.

MR. SCHWARZ: Your Honor, I think perhaps I might explain something about the organization of the NAIC, which would help to explain why Mr. Sturtevant is qualified [312] as any individual could be to be the one to lay the foundation for the introduction of this document.

The association is a combination of insurance commissioners from all of the states.

THE COURT: Right.

MR. SCHWARZ: And, they come together to promulgate general policies to be used by the various states in the conduct of examinations. They do this through a series of committees, meetings, and conventions, etc.

Ah—each of the insurance commissioners has his delegates within the state insurance department, who often represent him on these committees as Mr. Sturtevant has done, and each one is competent to say what NAIC policy is, especially to lay a foundation for an NAIC document which sets forth this policy.

I don't know who would be more qualified than he to —to lay the foundation for this.

THE COURT: Well, there must be some standing body that—ah—is comprised of a membership, competent to tell us when—to indeed identify some of this stuff. We just don't—all that I can see is you have got a paper here, that the other side hasn't seen. We have got a man from Georgia on the stand, and the—ah—aside from—as I indicated to you, the chronology problems, to the degree that you wanted this to show what people under [313] his direction and control in Georgia did, with reference to what was contained in the publication, I told you that would be fine, provided that he could put it in these peoples' hands in the relative period—in the relevant period. He doesn't seem to be able to do that.

But, then to go on and say well, but we want some—we want to show you what the practice was nationally, and in places where this man has no operational responsibility, or activity, I don't understand what—how—how he can—

MR. SCHWARZ: We are not trying to prove the law and regulations of—of the other states, anymore than we are trying to prove the law and regulations of Georgia by reference to this document. We are trying to show that—that the very form of this document indicates that examiners everywhere were using—were relying upon it; were relying upon the principles stated there in their entire work, and I don't see any way—any kind of condition, that could suggest that well, this principle wasn't applied—wasn't a general principle. It may not have been applied in New Hampshire, or Wisconsin. There

maybe specific exceptions I'm saying. But, the very structure of this document indicates that these were and had to be general principles of application, and we think in that posture, that's the important thing for this Court, [314] in this tax case to consider.

I don't think that the Court should be concerned with —if 48 states didn't follow it and two did, of course that would raise a question as to whether we were talking about a policy or just some minor statement.

THE COURT: All right, correct me if I am wrong. I thought the point of departure here was your directing the witness's attention to a passage, in Defendant's 7 for identification, and asking him a question that amounted to in substance, what did he think of this, on its merits. And, there was objection. And, I said that I thought that I indicated, that I would permit the witness so directed to tell us whether in fact the Georgia investigators applied whatever this is that you are referring him to, and that is all that I can see that he can do. I do not see that he can tell you about what somebody else may have thought, as to its—

MR. SCHWARZ: Your Honor, I'm analogizing Mr. Sturtevant's capacity here to the capacity of an expert witness such as an expert medical witness, would say what the medical practice is in the area, for example in which he practices, or to say—to state general mathematical principals, or principles that are used in—in any industry as a general matter. If he is qualified—

THE COURT: Well, you didn't—you didn't [315] offer him as an expert, did you? What were you qualifying him for? I thought you were calling him with respect to the role of the Georgia regulatory authority, in this matter.

MR. SCHWARZ: I didn't—Your Honor, I laid the foundation for—for both his qualifications as a Georgia regulator, and also as an expert witness with regard to insurance principles. I didn't specifically stop my questioning to offer him in that capacity, but I would like to do that at this time.

MR. MASINTER: And, I would like to object, because as I understood the witness's testimony for the last

ten years all he has done is serve as a chief examiner for the State of Georgia, and does not have any broad based knowledge or information or ability.

THE COURT: Well, I'll give you voir dire on his qualifications for general expertise. Now, if you want to offer him as an insurance expert at large, why don't you put your qualifying questions to him, and then we'll let Mr. Masinter voir dire on that?

MR. SCHWARZ: For the most part, Your Honor, the questions that I asked Mr. Sturtevant at the outset were the foundation for his qualifications, as an expert as well as a regulator from Georgia. I might ask one or two additional questions—

[316] THE COURT: Go ahead.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, up through and during the years in suit here, can you state how your general experience provided you with a broad background in the field of insurance regulatory practice generally, and also required you to be familiar with—with the general policies and principles involving reserves and all facets of—of actuarial and accounting practices in the industry?

A What exactly were the years?

Q The years in suit are from 1957 until 1964.

A From 1957 until September 1st, of 1960, I was a chief actuary at the Old Line Life Insurance Company of America. As chief actuary I had to familiarize myself with the legal requirements for operation of the company, in 17 states. I had to be aware of—I had to prepare the annual statements to the various insurance departments. I—ah—prepared and filed together with our legal department policy forms we used in the various states. And, I—ah—was available and used to a great extent whenever we had an examination by one or more insurance departments, answering their questions, and satisfying them that—in various operations of the company. We were complying with their legal—legal requirements, and also with regard to treatment of policy holders and stockholders.

[317] Q In the years subsequent to those in suit, which are the years in which you were with the Georgia Insurance Department, did you keep yourself abreast of general developments in the industry and throughout the industry in these same fields, as well as with changes in the Georgia law?

THE COURT: Excuse me, I thought he went with the Georgia Insurance Department during the period in suit, I thought that he went there in 1962.

MR. SCHWARZ: Yes, that's correct.

THE WITNESS: I started in February, 1963.

MR. GROSSMAN: Your Honor, let me say we are offering him as an expert right now, and not offering him as an expert back in 1957, which he may also have been an expert, but the crucial point is right now.

THE COURT: I thought, Mr. Grossman, that Mr. Schwarz suggested that he joined the Georgia Department after the period in suit. I simply wanted to find out if he really meant that, and apparently he didn't mean it.

THE WITNESS: Ah—from September 1st, 1960, when I retired from the Old Line Life, I spent about two years in consulting work, and then in—as of February 1st, 1963 I went with the Georgia Department, as chief actuary.

[318] BY MR. SCHWARZ: (Resuming)

Q In the years you were a consultant, and in the years during which you have been with the Georgia Insurance Department, have you kept up with the developments within the industry and within the NAIC generally, as opposed to just changes in the Georgia insurance law or regulations?

A Yes. I have to the extent that I have worked with the chief examiners of other states where we were having joint examinations, and also of course in the regulation of all of the insurance companies licensed in Georgia. I have become familiar with their operations under the departments of their own states.

Q And, have you attended meetings of—have you attended any NAIC conventions, and participated in other NAIC activities during those years?

A I have attended—

Q Excuse me, sir, could you keep your voice up a little bit.

A I have attended all of the regular meetings, that is the two annual meetings of the NAIC, except for the last two, which were in June—or in December of 1972 and June of 1973. I have also regularly attended the meetings of the blanks committee of which I was a member of the life section. And, at present I am on a committee which is examining and reviewing, and over- [319] hauling you might say, the entire examination process.

MR. SCHWARZ: That's the conclusion of my questions, Your Honor.

THE COURT: All right, fine. Do you wish for voir dire?

THE WITNESS: I—I might say as a general qualification that I am a member of the American Academy of Actuaries.

THE COURT: All right, Mr. Masinter.

VOIR DIRE EXAMINATION

BY MR. MASINTER:

Q What is the American Academy of Actuaries?

A It's a—an association which was formed, and it included—it was formed to include all of the various phases of actuarial practice, that is—it is a society of actuaries, the actuaries in public practice, external actuaries, associations, and so on and so forth.

Q How does one become a member?

A I became a member. I was admitted to membership on the basis of—of the educational qualification, and experience.

Q Did you take an examination to become a member?

A No, I wasn't required to take—

Q Just write a letter, and just say that you graduated from a certain school?

[320] A Sir, I furnished the membership committee with the—my records from the University of Michigan, and also a record of my—my work, as a practicing actuary, and as—I was recommended, I believe, by three members.

Q When did you graduate from the University of Michigan.

A 1917.

Q 1917?

A Right.

Q With what degree?

A BA.

Q And your speciality was actuarial science?

A Actuarial science, yes, sir.

Q What is the Society of Actuaries that you just referred to?

A That's a society which—well, it presently is a merger of two previous societies, one—the regional society was the oldest, I don't remember what—what its history is as far as the date of its formation. I think, but then there was another—I really can't remember it—it was the Eastern and the Western originally, and their membership became so—got together so closely that they merged into one society.

Q Were you a member of the society—

A No, I wasn't.

[321] Q You were not?

A No.

Q How does one become qualified to become a member of the society?

A By examination.

Q By examination?

A Right.

Q What type of examination would one take?

A Well, it is a series of examinations starting with covering ones proficiency in mathematics, particularly relating to—to the statistics and so forth.

And, then there is the—that leads into the final examination, which is based upon experience, ability of an

actuary to perform the duties that will be expected of him from his own experience.

Q I assume then that you must have taken these examinations?

A No, I didn't.

Q You never stood for the examinations?

A No.

Q So, that you are a member of the Academy of Actuaries, and not a member of the Society of Actuaries?

A Right.

Q And, how long were you with this insurance company as a chief actuary?

[322] A Ah—I went there in February of 1926, and I retired in September of 1960.

Q Retired in 1960?

A Right.

Q What was the retirement policy of your company?

A Age 65. Involuntary.

Q Pardon?

A Age 65 was required.

Q 65 was required retirement.

A Um-huh.

Q And, after the date of your retirement until 1963 you say you served as a consulting actuary?

A Yes.

Q And, what type of work did you do during that period?

A As a consultant—consulting work?

Q Yes.

A Oh, it was—it was pretty varied. I—ah—was—was consulted with regard to valuation of—perhaps the valuation of a life company for perspective purchase by another company. The—ah—the policy valuations required for the annual statements of—of numerous small companies which did not require—did not hire their own actuaries.

Q Where were these companies located?

[323] A In the area around Milwaukee, throughout the State of Wisconsin, and Northern Illinois.

Q Did any of them do business in Georgia?

A The only one—oh, yes, there are several of them that do, —the—

Q Did you actually perform work with respect to Georgia during those years?

A No.

Q How about Arizona?

A No.

Q How about Florida?

A No. I didn't do work for any state at that time.

Q No, I mean with respect to these companies qualifying in these states?

A Oh, I see, no.

Q You didn't do of that?

A No.

Q Now, when you were with this Old Line Company, did Old Line do business in Georgia?

A No, they do now, but they didn't at that time.

Q Did they do business in Arizona?

A They do now.

Q Did they then?

A No.

[324] Q Did they do business in Florida?

A No. The business was all north of the Mason-Dixon Line, and from Pennsylvania to the Pacific Coast.

Q So, then actually through 1963, until you came to Georgia, you really had never had any experience with the State of Georgia, is that correct?

A That's correct.

Q And, the same would be true of Florida and Arizona?

A Right.

Q I see.

MR. MASINTER: I have no further questions.

THE COURT: All right, now. What is the area of expertise for which you are now offering him, Mr. Schwarz?

MR. SCHWARZ: We are offering him to—to testify with regard to the principles underlying NAIC policy with regard—with regard to unearned premium reserves, with regard to reserves generally, and with regard to principles underlying the insurance industry principles,

NAIC policy regarding reinsurance, and the proper reserve to be set up in reinsurance agreements, and policy with regard to whether the reserves should be held by a ceding company or reinsurer under those agreements.

[325] THE COURT: All right, by virtue of his background and experience, I will hold that he is qualified to venture opinion—expert opinion on the substantive matters that you have indicated. I—however, this is not to be taken to mean that he is going to be the means of proving up what this NAIC as such thinks about anything. He can venture these opinions in his own right, as a qualified expert, and he can be cross examined about them. But, the publication can't be cross examined, and I don't think that the expertise that he has is in any way adds or furthers this business of—of trying to show what NAIC thinks about something. So, he is qualified as an expert in his own right, just as Eddy was deemed qualified so far as I am concerned, and in each instance, any reference by either of them to what NAIC thinks about something, I will regard as gratuitous.

MR. SCHWARZ: Your Honor, I—we would accept that limitation, but I would like to have it clarified with regard to one aspect of proof which we will also—offer during the course of examination.

THE COURT: Right.

MR. SCHWARZ: The NAIC has just adopted into the annual statement blank a series of interrogatories, and questions designed to determine whether a particular kind of reinsurance treaty is a so-called surplus aid contract. [326] If—and these will now be included in the annual statement blank, and as such under the laws of many states, which require that the annual statement blank be filled out according to its terms, it will become in effect the law of those states.

Mr. Sturtevant's experience—well, his position in Georgia will permit him to testify with regard to the application of the blank in the Georgia law, but I think that as an expert he could testify to his knowledge that this was done by the NAIC recently, and he should be able to lay the foundation for the introduction of those series—that series of questions and interrogatories, as a

basis for proving that they are the questions that have been introduced into the blank, and that that has actually been done.

THE COURT: Well, I don't know if I follow you, if what you are asking me is whether he is going to be held incompetent to say that he noticed that this NAIC bunch has said something, or recommended something, of course, that's not what—what I intended.

What I am intending in that regard as well as the general thing, is the proposition that this witness is not qualified to serve as this NAIC surrogate for purposes of its thoughts, views, policies, or anything else. He is not competent to vouch for those things.

[327] Now, as—you can speak to him about any proposition you want to, and in his own right he can—he can opine about it, but if it was so all fire important to hook the verity of any of these principals for which you are going to contend to this NAIC bunch, then I think somebody—I don't happen to see that it is, but if it—if that were the case, then I can only say that there should have been someone here from that body. And, the idea of analogizing that they are pointing out that well, he is a member, and the thing functions through members and all the rest of it, I—to me, as you well know, every legislative body functions through a group of members, but that doesn't mean that after the body has acted as a body, you can go poll the individual members, and ask them what they thought they meant at the time, or what the body meant at the time.

So, —ah—does that clarify what you—

MR. GROSSMAN: Yes, Your Honor, and might I say that the official proclamation of the NAIC speaks for itself, and that the witness certainly is competent as a general insurance expert to explain and interpret what the spoken or written words means, if there is any question about that.

And, we certainly don't ask him to promulgate more than the NAIC has officially promulgated in its own [328] document.

THE COURT: You can ask him what it means to him, and that's it as far as I am concerned.

MR. GROSSMAN: Okay. To him as an insurance expert, certainly, that's what we intend to do, Your Honor.

THE COURT: Proceed.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, again I would—ah—like to refer you to certain sections within this manual that has been offered—for which an offer of proof has been made, and refer you to specific sections, and ask that you review the purport of those sections, and then tell us whether—not whether it is NAIC policy, but whether these are generally accepted insurance principals with which you are familiar as an expert in insurance practice and policy. I refer you first to page B-14, and the heading which states, normal effect produced on the unearned premium reserve, and surplus of the ceding company by the session of reinsurance. Will you state your understanding of that explanation, and again whether that states general policy with which you are familiar, and—

A Yes, generally—ah—a company which reinsures a portion of its business in—ah—in companies which are—are approved by the home-state, as reinsurers, can [329] use the reserve that the reinsurer sets up on the policies that they pass on to it, from the total reserve liability that they report in their annual statement—in their homestate—financial statements to the department.

THE COURT: When you say home-state, are you talking about the state in which the insurance is written, or the—state in—

THE WITNESS: No, the domiciliary state of the—corporation.

THE COURT: The domiciliary state of the ceding company?

THE WITNESS: The domiciliary state of the ceding company.

BY MR. SCHWARZ: (Resuming)

Q The first sentence states, Mr. Sturtevant, an insurer may properly reduce the burden upon surplus by the reinsurance of a portion of its business in a manner

which transfers a part of its risk to another insurer. Is the policy implicit in that statement, as you understand it, a policy that the credit is basically designed to reflect the fact that a risk has been transferred from the ceding company to a reinsurer, or that regardless of whether premiums to cover that risk are immediately transferred, or transferred at some later date?

MR. MASINTER: If I might suggest, Your Honor, [330] the counsel's question suggests an answer from the witness, and I don't mind hearing what the witness has to say, if he has anything at all to say. But for counsel to sit there and tell him what to say is strictly another matter.

MR. SCHWARZ: Your Honor, I think that that question suggests two answers, and I have not given any implication as to which is the correct one. I would have it read back perhaps to indicate that, if you think that it is necessary.

THE COURT: That won't be necessary. I think that —ah—it is, Mr. Schwarz a heavily leading question. However, I still don't understand why this obsession with this—with this document. I mean why in the given instance the man qualified as he is, why can't he be called upon to—ah—in this connection to tell us where—ah—reinsurance occurs, what are the indicia that are looked to to determine incidents of—of underlying reserves. Is it—is it a premium matter per se, or is it a risk matter instead of this business of—oh, down in—in subparagraph 14-b, (2) of this NAIC bible, it says thus and so, and is that a good policy.

MR. SCHWARZ: I'll try to approach my question in another way.

THE COURT: Why don't you do it that way?

MR. GROSSMAN: Your Honor, might I also say [331] this objection has come up a number of times, that leading questions are proper in my understanding to an expert witness. Otherwise, an expert witness would take three weeks to present his testimony. And hypotheticals are definitely leading questions to witnesses.

If the witness were a fact witness, it would be another story, but if we are going to have repetitive objections

on the grounds that the questions are leading, we are going to be here for another three weeks. I think that that is a proper kind of question to ask an expert witness, and I would like to have that made plain right now.

THE COURT: All right, well, then, I will make something plain right now, Mr. Grossman. I would suggest that you further research the question—I'm well acquainted with the rules of having to do with an expert, and the differences in that connection, and a fact witness. And, if it is your impression that in the area of an expert, all you have to do is qualify the man, as an expert, and then hand him some publication, and say do you agree with it, and he can say yes, because he is an expert, then that is in a different book than I use. So, proceed, Mr. Schwarz.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, is it your understanding that [332] the basis for the credit which is allowed a ceding company for reinsurance is that the ceding company has transferred part of its risk to another insurer?

A Well, that is the criteria of reinsurance. Reinsurance is the passing of risk.

Q And, what is the normal effect upon the unearned premium reserve and surplus of a ceding company and a reinsurer from the cession of reinsurance?

A The—ah—the ceding company transfers to the reinsurer a specified portion of—of the risk, which is undertaken, and a company's at cession with the proper premium, provided by contract, and thus the—ah—ceding company deducts from its total reserve that reserve which is set up by the reinsurer to cover the risk.

THE COURT: When you say the proper premium, and I believe that you added, determined by contract, do you mean that from the standpoint of the regulatory bodies that the parties are free to decide among themselves what the proper premium is for the—the relief on the one hand, and assumption on the other of the risk in question?

THE WITNESS: Yes—that's true.

THE COURT: I see. You are telling us then, that the regulatory body does not examine for itself, [333] quantify or qualify the—the risk in question, and—and —ah—indicate to the—to the parties to the treaty the requisite reserve that should follow over with that transfer of risk?

THE WITNESS: The—the—reserve, of course, is governed by the minimum reserve laws of the homestate. But, the premium, which may be charged is a matter of contract between the companies.

THE COURT: Proceed.

BY MR. SCHWARZ: (Resuming)

Q Would the unearned premium reserve that the reinsurer sets up be the same unearned premium reserve in amount that the ceding company has taken credit for?

A It would be, in the case of a gross premium—unearned gross premium reserve.

Q Is that true regardless of the particular amount that the ceding company agrees to pay the reinsurer as the reinsurance premium?

A I'm not sure that I understand your—

Q Let's take a hypothetical, where $100.00 in premiums are received by the ceding company. Would the ceding company set up an unearned premium reserve of $100.00 initially in a case like that?

A That—that would be true.

Q If it agreed with the reinsurer to reinsure the [334] full liability it had assumed for a reinsurance premium of $97.00, let's say, it would take a credit on its books for $100.00 is that correct?

A Ah—

Q The ceding company would take credit for $100.00?

A The ceding company would take credit for whatever reserve the—the reinsurer set up in its liabilities.

Q Well,—

A On that particular principle.

Q Wouldn't the reinsurer be required to set up the reserve for which the ceding company had taken credit?

A Ah—yes.

Q Now, the question is then, what is the unearned premium reserve in the example that I have given you—well, let me ask you is that a typical situation where a ceding company will reinsure a liability and transfer most of the premium that is received as consideration, but keep a small commission for the reinsurance?

A Ah—this is—this is quite often—

Q Now, where that is done, with the ceding company take a credit for the full unearned premium reserve, which it had initially set up?

A Yes.

Q And, is that the amount of unearned premium reserve which the reinsurer would set up?

[335] A Well, the reinsurer—the amount of reserve that the reinsurer would set up would have to be the same as the ceding company took credit for.

Q Then, what is the specific answer to my question, if the ceding company took credit for $100.00?

A The reinsurer would set up $100.00.

Q Is it proper—would the proper credit that the ceding company takes be $100.00 or in my example would it be something lower than $100.00?

A It would be $100.00.

Q I see. Is the normal—in the normal reinsurance arrangement, is the full premium for coverage over the period for which the insurer cannot cancel remitted to the reinsurer at the time that the insurance is taken out?

A This I think is—is generally, not always, the case in accident and sickness. It may be different in life.

Q Can you tell us your understanding of what the term surplus aid contract means in the insurance industry?

A Yes. Ah—the name surplus aid is applied to a contract which is entered into without the actual transfer of risk from one company to another, but under which the —ah—the ceding company escapes the necessity [336] of setting up reserves by means of a contract with a reinsurer, which does set up the full reserve, but under which the ceding company actually—eventually pays all of the —the things that have been brought against it.

Q I see. Before I continue with the discussion of the surplus aid contract, I would like to return to the question of the credit for $100.00 if I may. Are there situations where a—a reinsurer will not be authorized to do business in the domiciliary state of the ceding company, so that the insurance department of the ceding company might refuse to allow that ceding company to take credit for an unearned premium reserve?

A Yes, this is true.

Q Are you familiar with the examples where that occurred?

A I can't name specific examples, but every—but practically every statement of a company which does a large amount of business will carry in its liabilities certain amounts which are—are reserves on ceded reinsurance, which it cannot take credit for in the state to which it is making its report.

Q Now, would that credit be prohibited in those situations even though the reinsurance premium had already been paid over to the reinsurer?

[337] A Sure.

Q I see. What is the basis for disallowing the credit under circumstances like that?

A The fact that the reinsurer has not been approved for operation in the state where the ceding company is domiciled.

Q Now, returning to the discussion of—

THE COURT: May I—may I ask a question at that juncture, Mr. Schwarz? Assuming that the—or rather in those instances where the reinsurer is approved by the ceding company's reinsurer authorities, is there a—well, has there been in the states of your experience, a consensus on the matter of—of—ah—reserve coverage for the particular risk reinsured. The consensus that I am trying to find out about is, when you are dealing in a reinsurance situation with an approved or authorized reinsurer, does the ceding company's domiciliary regulator tend to view the ceding company and the reinsurer as a unity for the purposes of—of reserve adequacy inquiry, that is to say do they look at this in terms of—of a risk, and simply satisfying themselves that—ah—

with the ceding company and the reinsurer that risk is adequately secured by reserve, or do they in that inquiry discern and discriminate between the ceding company and the reinsurer, and attempt to satisfy themselves as to [338] who is—is underwriting if you will in this sense, what part of the risk involved?

THE WITNESS: No, I think—I think that the best picture I could give of it would be that this is regarded as a sharing risk. We looked upon each company's—we judge—we judge the value of the risk, and the company's ability to pay it, to pay claims under it, on the basis of —of—

THE COURT: On an individual or a pooled basis?

THE WITNESS: On an individual basis. The reinsurer, and the ceding company both being able to meet their share—responsible share of the risk that they have assumed.

THE COURT: Well, then, let me see if I can test what you have told me. If you had a situation, reinsurance—approved reinsurer, whereby virtue of the treaty, the reinsurer had assumed 100 percent of risk of loss liability, and the ceding company maintained 100 percent of the reserve that you the regulator felt was necessary to maintain in respect to the total risk, you would or wouldn't approve of that arrangement?

THE WITNESS: Ah—

THE COURT: As a matter of regulatory practice?

THE WITNESS: No—ah—what we would do, we would—we would assume that the company who has assumed the reinsurance has either received or will eventually [339] receive the premium—the total premium, which should be carried as—as an asset. And, then set up against that a liability for the commission which would be payable to the ceding company, and also for the reserve.

THE COURT: Proceed.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, in answer to the—to the question posed by Commissioner Willy, are you suggesting that even where the ceding company has set up the unearned

premium reserve on the policies, that it would be proper for the reinsurer to set up an asset reflecting its right to receive premiums in the future, and offsetting unearned premium reserve liability?

A Ah—yes, to the extent that—that it expects to receive some—some—if it hasn't received the whole premium with the reinsurance cession, but still expects to receive some portion of it, then that portion should be set up as an asset,—

Q Would, an asset—

A With an offsetting liability, of course.

Q Would the asset account be called premiums in course of collection?

A It could be, something of that sort.

Q And, is that an admitted asset where it is set up? [340] A Yes. Now, in the case of—of reinsurance, such as we are talking about, it would be accepted as an admitted asset.

Q Under the first treaty involved in this case, would it have been proper for Consumer as the reinsurer to set up the asset and liability accounts which you have just spoken of?

MR. MASINTER: I object, I have not heard the witness testify as to any familiarity with the treaty at all.

THE COURT: Sustained, restate your question.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, are you familiar with the reinsurance treaty between American Bankers and—as the ceding company, and Consumer Life Insurance Company, as the reinsurer, which has been introduced as Plaintiff's Exhibit 2 in this case?

A I've read the treaty.

Q And, you are familiar with the treaty?

A Yes.

Q All right. Now, you just described an asset, and unearned premium reserve liability account that would be set up by a reinsurer under circumstances where the ceding company also sets up the reserve. Would it have been proper for Consumer under that 1957 to

have set up [341] this asset account premium in the course of collection, and an unearned premium reserve liability account you have just described?

A I believe that that would be a proper accounting procedure, since it fully discloses what the condition of the company is, and its operation.

Q Was it also proper for them not to reflect that asset and liability account, as in fact they did not in their statements, or was it a violation of some law to do that?

A Ah—well, in—listening to the—to the previous—ah—in relation to this thing, I have heard the expression reinsurance as earned, premiums as earned. I don't think that this is quite a proper description, and I don't think that it relieves the reinsurer of—of the necessity of setting up the full account, because the—the ceding company has accepted a single premium, covering—let's say 12 months or whatever it happens to be, and the reinsurer has accepted, if it has accepted the risk, it has accepted it with the expectation that it is going to get all the premiums.

Q And, that's the basis for your requiring—your feeling that this should be set up?

A I would say so.

Q Had you suggested that by not setting it up, [342] the—the—the Consumer's annual statements did not fully reflect the credit accident and health reinsurance business which it was doing?

A I would—I would say so.

MR. SCHWARZ: Your Honor, I—I would like to go into the surplus aid kind of contract in some detail that I referred to earlier, unless we want to wait for another half, or three quarters of an hour to go to lunch, it maybe appropriate to adjourn at the moment.

THE COURT: All right, why don't we recess then, we we'll reconvene at 1:00 o'clock.

(Whereupon, the hearing in the above was recessed at 11:55 as described above.)

* * * *

[343] DATE: July 18, 1973

* * * *

[344] AFTERNOON SESSION

THE COURT: Are counsel ready?

MR. SCHWARZ: Ready, Your Honor.

THE COURT: Before you proceed, I would like to ask the witness, you were speaking at the recess about reserve practices in reinsurance situations, and I would like to know, Mr. Sturtevant, what significance, if any, do regulatory authorities attribute to the consideration of who as between ceding carrier, and reinsurer has the premium monies in determining who as between the two what to be reserving and what amounts, what is the significance of—of possession of premium monies in that connection?

THE WITNESS: Well, we our primary concern I think would be that the reserves are held by the—the party assuming the risk. Now, I don't lay that down as an absolute law, but it would be most unusual and the circumstances would have to justify the departure from that.

THE COURT: Well, put otherwise then, are you telling me that the—to your knowledge, the regulatory authorities would not simply make a mechanical inquiry, that is to say as between the two, attempt to discern who has the premium dollars, and then just automatically look to that party, and see whether he has set up a requisite reserve, are you saying that that would not be the—

[345] THE WITNESS: We would—we would assume first that the party who receives the premiums has the risk.

Now, if reinsurance is obtained and part of that risk is transferred to another company, the premiums should follow,—

THE COURT: I see.

THE WITNESS: As I have said a little earlier, either—they have either got it in hand, or they expect to get it, and carry it as an asset,—with offsetting—

THE COURT: All right, so that the—the location, if you will, of the premium dollars is an indication of reserve requirement in those instances where the premium dollars have been apportioned in—in accordance with risk, is that what you are saying?

THE WITNESS: Right.

THE COURT: All right, proceed.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, before our noon break we discussed very briefly the notion of a surplus aid contract, and in order to refresh the Court, will you again state your understanding of what a surplus aid contract is?

A Surplus aid contract is—as we use the term—regulators usually use the term, is a contract under which risk is not actually transferred from one company to another. A contract is entered into by which certain—[346] the premium is divided into commission and—ah—reserve factors. But, under which the—the reinsurer usually receives a guaranteed profit of say three percent or five percent, or whatever it may be, and the—the original—the ceding company actually then pays out—may pay out claims up to the dollars that it has—paid over to the reinsurer, and if it goes beyond that, then the ceding company has to pay the remainder of the claims itself, anything over and above the premium—the premium and the three percent.

Q Are you familiar with the term guaranteed profit contract?

A Yes.

Q Is a guaranteed profit contract a type of surplus aid contract?

A Yes, it is.

Q All right. Where it refers to guaranteed profit, whose profit is guaranteed in these situations?

A The reinsurer.

THE COURT: Mr. Sturtevant, does Georgia for its purposes ever have occasion to classify insurance companies as life or other?

THE WITNESS: Yes—

THE COURT: Does Georgia have a definition of what a life insurance company is?

[347] THE WITNESS: Yes, it does. The Code provides for five classes of insurance, life and accident and health is class I; casualty is class II.

THE COURT: All right, now how do you determine if you just go out here, and you—you are walking down the street, and you see a sign hanging out from a building, that says insurance company, and you decide, well, I'm going to walk in there, and I want to find out what kind of insurance company they are, what do you look at to determine in which of these classes or categories they fall?

THE WITNESS: Ah—most—most life insurance companies have the word life somewhere in their title, although some do not.

THE COURT: Well,—but as function, what would you look at?

THE WITNESS: As a function, the company might write just life insurance, it might write just accident and health insurance or write both, as most of them do.

THE COURT: All right, you find after you get in the lobby there, and look around a little bit, that they're writing some of each of these five categories that you are talking about—

THE WITNESS: Ah—

THE COURT: Now, if you wanted to decide [348] whether—you indicated that there would be some purpose under Georgia law, in which it would be relevant as to whether or not they could be considered a life insurance company, or a life and health and accident company—

THE WITNESS: Well,—

THE COURT: What would you examine for that?

THE WITNESS: The Georgia code does not—does not prohibit a company from writing all types of insurance under the five classifications, however—excuse

me, it is a policy of the department to discourage it, and to date only one such company is licensed in the state, and that is Travelers Insurance Company.

THE COURT: All right, proceed.

BY MR. SCHWARZ: (Resuming)

Q Did I understand, Mr. Sturtevant in answer to that question, that life insurance companies in Georgia with—with the exception of this one company that you mentioned, write no other kind of coverage except life and accident and health?

A That's true.

Q Is that generally true throughout the country?

A I think that it is, I don't know of any place where —there are no other—no companies from any other state that license to Georgia the credit—

Q Are you familiar with the qualification ratio [349] we were discussing earlier to use as a basis to determine whether the company qualifies for tax purposes as a life insurance company, were you here when we discussed that ratio?

A Yes, I'm familiar with that ratio.

Q Based upon your understanding of the types of insurance which life insurance companies—so called life insurance companies write, would you say that the question then is whether most of its business is accident and health business or most of it is life business?

A Well, of course, for tax determination, it's ratio of reserves, actually the same ratio might—not apply if it were based on premiums.

THE COURT: Now, you say you are familiar with that statute, and if you will recall as Mr. Masinter pointed out this morning, it has got a catch-all reference to all other reserves, is there some table or directive somewhere that tells us what reserves an insurance company has to maintain, what types of reserves?

THE WITNESS: The—yes, the standard reserve law does—enumerates life insurance,—accident—life insurance and annuities, accident and sickness insurance, group insurance of both accident, sickness and life—

THE COURT: May I ask you is there more than [350] one reserve required for each category or type of insurance?

THE WITNESS: There is—ah—sometimes more than one reserve required for accident and sickness insurance for example. Policies are issued on a guaranteed renewal basis. They require a little additional reserve. The non-cancellable policies require an entirely different type of reserve.

THE COURT: But that's just a reserve different in amount, isn't it?

THE WITNESS: Well, this is true.

THE COURT: I mean, if you had cancellable, A&H, and you had non-cancellable A&H, you would still, wouldn't you just require the—the carrier to maintain a single reserve for each of the two categories?

THE WITNESS: No, the two reserves are—there are different columns in the annual statement report covering accident and health business for the two kinds.

THE COURT: All right, proceed.

MR. GROSSMAN: Your Honor, I believe that there is a separate reserve called an additional reserve which covers the non-cancellable portion of the accident and health policy that is non-cancellable, is that correct?

THE WITNESS: Yes, and in the Exhibit G there is a complete segregation.

[351] BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, just as an aside, unpaid loss reserves are required on both life insurance and accident and health insurance, are they not?

A Yes.

Q And, they are different from the life insurance reserves, and the unearned premium reserves that we have discussed for the most part here?

A Right.

THE COURT: That would be an illustration, Mr. Schwarz, of "other reserve", within the contemplation of 801? Is that what you mean?

MR. SCHWARZ: Your Honor, I believe that unpaid loss reserves are separately enumerated under the first two aspects of the definition of total reserves, so I don't think that it would fall under the all other reserves category.

THE COURT: Well, in any event, the catch-all category has no meaning in our context?

MR. SCHWARZ: It has no meaning in our case, the regulations do state a number of reserves that do and do not qualify under the heading total reserves, but they aren't relevant to this case.

THE WITNESS: Your Honor, may I make a correction in my testimony here?

[352] THE COURT: All right.

THE WITNESS: I referred to schedule G, it should have been schedule H.

BY MR. SCHWARZ: (Resuming)

Q I refer you to the unpaid loss reserves, Mr. Sturtevant, are those as between a ceding company and a reinsurer, is the company required to maintain the unpaid loss reserves, the company that has the—the risk under the policies?

A Ah—each company would maintain its own—I believe though in most cases, the—the ceding company would set up the loss—the entire loss reserve, and then simply bill the reinsurer for their share of it.

Q Does anyone ever take credit for loss reserves, as they do for unearned premium reserves on reinsurance?

A Ah—yes, we have a place on the asset side of the annual statement for—amounts due from reinsurers, and this is in primarily to cover losses which have been incurred.

Q Would that amount to a ceding company taking credit for unpaid loss reserves under circumstances where it has reinsured—

A That's what it would amount to. It is an offset against their liability.

Q I see, and then would the reinsurer set up the [353] unpaid loss reserves on its annual statement?

A No, it would set up a liability, I believe, for losses payable to—to ceding companies.

Q And, is that tantamount to the unpaid loss reserve?

A Yes.

Q Let me give you a hypothetical situation, Mr. Sturtevant. Consider a situation involving reinsurance of accident and health business, the ceding company enters into a reinsurance treaty under which at least initially its liability is reinsured with the reinsurer. It pays to the reinsurer the gross reinsurance premiums less commissions—let's assume that the commissions are 45 percent of the premiums that he receives, making a net of 55 percent of the premiums that it receives payable over to the reinsurer. And, under this hypothetical arrangement, as losses are determined, they are paid by the reinsurer, and until the reinsurer has received back—I'm sorry, until the ceding company has received back from the reinsurer losses recovered in an aggregate amount, equal to 52 percent of the premiums that were originally received, and that 52 percent amounts to the 55 percent that the ceding company paid over to the reinsurer, less a three percent fee for the reinsurer. Now, if the losses under this hypothetical exceed the amount of premium payable back to the ceding [354] company, the ceding company would be obliged to pay over the balance to the reinsurer. Do you consider that hypothetical to be an example of the surplus aid contract?

A Yes. It is a guaranteed—guaranteed profit surplus aid contract.

Q What is the ultimate effect of this contract on the reinsurer?

A The ultimate effect is that the reinsurer receives three percent as a fee for enabling the ceding company, so called, to pay its claims over—in installments you might say.

Q Under such a contract you understand that the ceding company is maintaining the full risk under the—under the policies throughout the period of the contract?

A That's the result of it—the ultimate result.

Q I see. Are you familiar with ceding companies taking credit for unearned premium reserves and having reinsurers set them up under such contracts?

A No, I'm not. This is—this is the first such contract that I have seen—actually seen.

Q Are you aware from the testimony in this trial, that other companies do this as well?

A I—I understood that that was—that that was stated.

Q By—you said that this was the first contract [355] that you—this is the first contract of this sort that you have received, are you referring to the Plaintiff's Exhibit #3, the 1962 treaty?

A Yes.

Q And, is that treaty an example of a surplus aid contract?

A Yes, it is.

Q Is it similar in effect and operation from the hypothetical example that I have given you?

A I think that it is.

Q I didn't hear your answer.

A I think that it is.

Q Does the Georgia Insurance Department have a policy with—regarding to allow it—with regard to allowing a ceding company to take credit for the unearned premium reserve under policies of this sort?

A We—we follow the—

Q Excuse me, under treaties of this sort?

A Yes. Under treaties of this sort we would—

MR. MASINTER: I object, he has already said that he has never seen one before.

MR. SCHWARZ: That doesn't mean that they don't have a policy.

THE COURT: Do you understand the question?

THE WITNESS: I think that I do.

[356] THE COURT: All right, well, you may try to answer it.

THE WITNESS: I think as—I really answered this a little earlier in that I would consider that the proper accounting under such a contract would be for the—the reinsurer to set up an asset of premiums in—in transit

or something of that sort—anticipated premiums and an offsetting liability of reserve, and—and commission.

BY MR. SCHWARZ: (Resuming)

Q Now, I—I—

THE COURT: Well, excuse me, Mr. Sturtevant, he didn't ask you what good accounting practice for such a situation was, I thought that he asked you if you knew whether Georgia had a policy with respect to such situations, and you said it did?

THE WITNESS: Well, —ah—

THE COURT: What's the policy?

THE WITNESS: Georgia—

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, let me state that policy question more clearly. In the circumstance involving the surplus aid contracts, where the ceding company doesn't really transfer any risk, but enters into a reinsurance agreement, my question was, does Georgia have a policy [357] with regard to whether the ceding company is allowed to take credit for the unearned premium reserve, which it initially sets up?

A Oh, I'm sorry. No, we have no such policy, we've never been confronted with it—with the necessity of making a decision on such a case.

Q You don't have any policy with regard to—

MR. MASINTER: He just said that he didn't, there is no point in pursuing it.

MR. GROSSMAN: I'm sorry, would the opposing counsel please allow our parties to finish—

THE COURT: Well, no, I think that that is fair enough, he did say that they had no policy, and it seemed to me that he didn't indicate any uncertainty or misunderstanding about what he was being asked.

MR. GROSSMAN: I don't think that we had completed our question, Your Honor.

BY MR. SCHWARZ: (Resuming)

Q Sir, let me—let me restate the question in light of the example that I give you.

I asked you whether you thought that Plaintiff's Exhibit #3, the 1962 treaty, was an example of a surplus aid contract, and you said it was, I believe?

A Yes.

Q All right. Are you aware that under that treaty, [358] the Plaintiff, Consumer Life was the ceding company?

A Yes.

Q And American Bankers was the reinsurer?

A Right.

Q And, under the treaty Consumer Life didn't really transfer any risk to the reinsurer?

A Um-huh.

Q And the question was whether it could take credit for the unearned premium reserve that it set up under that treaty?

A It—it could not take credit for it.

Q It could not?

A No.

Q Why do you say that?

A Well, because the contract itself is of a nature which we would not permit the credit to be taken.

Q Do I understand, then, that it is Georgia policy that—that under those circumstances Consumer would not be allowed to take credit for the unearned premium reserve?

A That's right.

Q You answer the same question contrarily before, is this the correct answer?

A I thought—

Q Did you perhaps misunderstand my earlier.

[359] A I misunderstood your question the first time.

Q I see.

THE COURT: Why is it that you won't permit them to take credit for the—

THE WITNESS: Because we don't think that it is a valid reinsurance contract. If there is no risk in our opinion, there is no risk transfer, and it is not a valid reinsurance.

THE COURT: Well, who is that was seeking credit for the reserve, I thought that it was the ceding carrier?

THE WITNESS: The ceding carrier is the one who would seek credit for the reserve, but we would—

THE COURT: And the test—and the question is—or the hypothesis is, that it has not transferred, it has not laid off any risk with the reinsurer, well if it is standing as the sole risk holder, what is the matter with it retaining the reserve?

THE WITNESS: Well, it does—it should retain the reserve. The question was—

MR. SCHWARZ: Your Honor, the question was—excuse me, I think that I could clarify the question that you asked by saying that the—in this situation, the Plaintiff is attempting to take credit for the reserve so that it doesn't include the unearned premium reserves in its qualification formula.

[360] And, the Georgia Insurance Department, I believe that Mr. Sturtevant testified, would not permit Consumer under these circumstances to take that credit, because the reinsurance did not actually transfer any risk.

THE COURT: You're using take credit to mean exclude?

MR. SCHWARZ: Yes, that's the way that the term is used in the—in the answer.

THE COURT: All right.

BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, are you aware of any—that some states do permit a ceding company to take credit for unearned premium reserves or that they have in the past under treaties of this sort?

A Ah—

MR. MASINTER: Your Honor, may I hear the question again?

THE COURT: Read it back.

(Whereupon, the Reporter played back the tape as requested.)

MR. MASINTER: In other words the question—I got a little bit confused, is your question—is he aware that other states permit this—taking credit, is that the question was?

[361] MR. GROSSMAN: Yes, have permitted taking credit in the past.

MR. SCHWARZ: Have in the past permitted companies to take credit for unearned premium reserves under treaties of this sort.

THE WITNESS: I don't—I can enumerate any—I couldn't specify any who—that I know of.

BY MR. SCHWARZ: (Resuming)

Q Are you aware of some controversy that existed?

A I have heard—I have heard hearsay on the matter.

Q Have you discussed it with other people in the industry?

A Right—um-huh.

Q So, you are familiar with the controversy?

A Yes.

Q Are you aware that—that whether any committee or sub-committee of the NAIC has considered the question of whether the credit ought to be taken under policies of this sort?

A Well, the—the Commissioner's handbook itself specifies that they shouldn't take credit for it. And, the committee of the NAIC, which is a standing committee on examinations, has this under consideration all the time.

[362] Q Has the blanks committee of which you were a member considered reflecting its concern about these treaties in the annual statement blank?

A Yes, there is a question in the general interrogatories, question number 3½ which states that—starts out by saying that if this company was reporting has reinsured any accident and health business for another company, it should carry the full reserve on that, and then it says, has this been done?

Q Are you aware that the committee has considered including some interrogatories in the annual statement blank in order to determine whether the company has surplus aid contracts?

A Yes, such a series of interrogatories was adopted by the sub-committee A-1 blanks committee, and submitted to the parent committee at the meeting in Washington, last June, and I understand from the Secretary

of the NAIC, in the Central Office in Milwaukee, that this was adopted by the Executive Committee of the NAIC for inclusion in the 1974 annual statements, and hereafter.

Q Now, is the effect of this inclusion of these interrogatories on the annual statement blank that they will be part of the blank and the companies will all have to answer these questions?

A That's right.

[363] MR. MASINTER: If Your Honor please, I object to any further questioning about this. I have no idea of what he is talking about, and I don't think that it has a blooming thing to do with this case.

THE COURT: Well, I don't think that it has enough to do with it to be relevant, really to talk about what a carrier's status in 1958 through 1964 is, by reference to some—I suppose it is a little more than a trial balloon, but in any event, some thinking or—or classification that's being made in 1973, I think is too remote, Mr. Schwarz.

MR. SCHWARZ: Your Honor, we are aware that the law at the time of the years in suit is a relevant law. We are dealing with principals here that were applicable to produce this result then as well as now. And, the fact that two alternatives can be pursued within those principles, one which does not comport with our understanding, another which does, does not mean that later developments should not also be considered.

THE COURT: Well, that's right, but I—

MR. SCHWARZ: We aren't saying that principles have changed in that time, we are saying that the principals that existed then have been given a fuller explanation in terms of later developments, and in that respect I think that later developments are relevant to this Court.

[364] THE COURT: You are looking to what this NAIC crowd does in 1973 to show what they meant in 1964?

MR. SCHWARZ: I'm not trying to prove anything about what the NAIC thought back then. I'm trying to show the significance of the general principles underlying reinsurance and unearned premium reserves, that

those principles are illustrated through this particular manifestation, namely a surplus aid contract, which is an unusual kind of contract that results in a rather unusual result, and great significance is given to these principles by the way in which these contracts have been handled.

The interrogatories will now be on the annual statement, they will be the law of many states, now as a result of being on that statement.

And, I think that that has great probative value in this Court's consideration of what a reserve was back then, what it meant, what the term unearned premiums meant.

And, I would like to introduce the interrogatories into evidence as a way of showing that this contract is covered by them, and I would like to have the witness identify the interrogatories as being the ones that will be included on the statement blank, without trying to say [365] that the Plaintiff did anything illegal back in the years in suit.

THE COURT: Well, that's understood, but that really isn't the question, Mr. Masinter, do you want to say something?

MR. MASINTER: When you are through, Your Honor.

THE COURT: Go ahead.

MR. MASINTER: Well, I would suggest that if we are going to pursue what the NAIC is doing today and continuing to do next year, and might have done last month, that we will never get through with this trial.

Either, the NAIC, rules and application were relevant to the years in issue in this case or they weren't. Now, I don't know what the NAIC did last year or next month, but I think that it has absolutely no relevance to this case. I don't understand them. I don't know what he is trying to get at. I have no idea as to what these interrogatories are, and I don't know that they have ever been brought into issue in this case at all—ever. And, I think that it is totally improper and I think that it is just taking up our time.

MR. SCHWARZ: Your Honor, it seems that Mr. Masinter's objections are going to some kind of a ques-

tion as to whether the treatment of the taxpayer by the [366] Arizona Insurance Department, for example, during the years was right or wrong. The Government hasn't raised that issue, and we don't think that it is one that we need consider.

If that is not his objection, then I don't understand his objection. And, if that is not it, it seems to me that these considerations are—are quite relevant to the general policy considerations, which the State law is relevant to in this case.

THE COURT: Well, did you—as you know, Mr. Schwarz, there was a pre-trial order issued in this case. One of its provisions required the Defendant to set forth or identify and set forth the documents on which it proposed to rely. Have these interrogatories ever been so noticed?

MR. SCHWARZ: No, they haven't, Your Honor. The reason that they have not is because we felt that the most probative evidence of the conclusion that we were trying to make would be a document which would evidence the adoption by the NAIC of these interrogatories as they came forward through the various committees.

And, that just occurred in June. We have been making attempts since then to get such a document, and we have not been able to. And, therefore we have introduced that fact through the witness who ascertained the fact. [367] The document that I am holding here is a document dated March 8th, 1973, which is a transmittal of these interrogatories from one committee that considered them to the blanks committee, which in turn referred it to the NAIC. I did not expect to introduce this, because I didn't think it would be the best evidence. And, it is only because of this late development that I feel it necessary to introduce this now.

And, I am certainly willing to give the Plaintiff's counsel an opportunity to review it.

THE COURT: Well, I take it while there hasn't been a formal offer, there will be objection, and it will be—if nothing else on grounds of chronological relevance, and pertinence to the issues at hand. On that basis and in view of the fact that this is a new matter, I will

sustain the objection, and I would suggest that you make an offer of proof with regard to this as you did the other material, Mr. Schwarz. And, let it be marked, of course, for identification, so it goes up with the record.

MR. SCHWARZ: I would like to mark this document for identification, as Defendant's Exhibit—

THE REPORTER: Number 8.

MR. SCHWARZ: Number 8.

THE REPORTER: Defendant's Exhibit number 8 marked for identification.

[368] BY MR. SCHWARZ: (Resuming)

Q Mr. Sturtevant, will you identify this document marked for identification as Defendant's Exhibit number 8?

A Yes. Yes, this is the proposed change in—this is the proposed change in the annual statement blank.

Q Would you identify the first page of the document please?

A Ah—this is a letter from the Senior Vice President of the Lincoln National Life Insurance Company transmitting this proposed amendment—let's see—from the B-7 Sub-Committee, to the—

Q What's the name of that committee?

A The B-7 Sub-Committee was a committee on rehabilitation and—I forgot what that—let's see—

Q Does this refresh your recollection, Mr.—

A Yes, rehabilitation and liquidation. This is Sub-Committee B-7, elimination of reinsurance offset, and model rehabilitation and liquidation act. And, this was transferred from the B-7 Committee to the blanks committee, sub-committee A-1.

Q Was Mr. Steere the gentleman you mentioned as writing the letter acting in his capacity as a member of the B-7 Sub-Committee?

[369] A No, Mr. Steere was not a member of the B-7 Sub-Committee. He is a—an industry man, who was on the Industry Advisory Committee, which was suggesting two changes in the material as submitted to them.

Q I see. Would you identify the attachment to the three—to the one page letter attached?

A Well, this is the proposed interrogatory 21-A, which would appear on page 17 in the general interrogatories of the annual statement. And, it would be designated as interrogatory 21-A.

Q What other changes are described in this attachment to the annual statement blank?

A Ah—a number of questions concerning ceded reinsurance, all of which were designed to determine the extent to which a disallowance of a reserve credit would affect the surplus of the company involved—adversely affect the surplus.

Q Is it an attempt to define which contracts are the sort for which the credit should not be allowed?

A I think—think that the intent of it was to get down in definite form a—a formula for determining when a company's reinsurance contract was satisfactory for the allowance of the reserve against the total reserve or not.

Q Have you reviewed—

[370] A This had been—excuse me.

Q Go ahead.

A This has been a matter that has been argued back and forth many times, and they wanted to get a definite way to identify these things.

Q Have you reviewed these questions?

A Yes, I have.

Q And, do you find that Plaintiff's Exhibit number 3 falls within them as a type of contract for which the credit would not be allowed?

A It definitely does.

MR. SCHWARZ: Your Honor, we make an offer of proof of this document, and if accepted into evidence the document would prove the amendments that have been made by the NAIC to the annual statement blank affected the 1973 blank.

THE COURT: And, the pertinence being that this would reflect that NAIC would not authorize attribution of the A&H reserve to American Bankers under the Plaintiff 3 contract?

MR. SCHWARZ: Yes, it would also—we also offer to give further elaborations in support of the general principles underlying unearned premium reserves within the industry, quite apart from the NAIC policy.

Excuse me, would you give us one moment, Your [371] Honor?

BY MR. SCHWARZ: (Resuming)

Q Do you understand, Mr. Sturtevant, that the—that the interrogatories—the subject of this proposed Exhibit and—are designed to correct the situation to which the NAIC has voiced objection in the past?

A Yes, that's—that's its purpose.

Q So, this is not some new policy on the part of the NAIC, it is really a new way to give effect to that policy?

A It is a result of a long—of a long study.

Q And, is is also a result of a policy that has been long standing?

A Right.

THE COURT: Well, I thought that he testified a couple of minutes ago that all he knew—he didn't know anything about any policy, but that he had heard some discussions, some controversy I think he put it, in connection with this NAIC group, isn't that what you said, Mr. Sturtevant?

THE WITNESS: No—ah—the thing that I said that I had only heard discussed—

THE COURT: Right.

THE WITNESS: Was a—a contract which would permit a company to carry—ah—carry reserves which was [372] the ceding company rather than the reinsurance company.

MR. SCHWARZ: I think that he was just referring to examples of—other contracts of this type, rather than—

MR. GROSSMAN: I believe just to clarify it,—the record will show that the prior question related to controversy, and the present question was to a policy of the NAIC, and I think that the transcript will show that when it is typed.

THE COURT: Are you telling us, Mr. Sturtevant, that at some discernible, identifiable date, this NAIC group reached and announced a fixed aversion to the practice of a—of a reinsurer being permitted to carry an unearned premium reserve under a so-called surplus aid type agreement?

THE WITNESS: The—ah—as long as I have been attending blanks committee meetings, for example, this has been a matter of discussion—

THE COURT: Right.

THE WITNESS: Between the members of the blanks committee.

THE COURT: Fine. Well when, if you can tell us, did the body—this thing called NAIC reach a house-view in respect to this question?

THE WITNESS: This was at the time that the [373] committee on rehabilitation had drawn up this proposed addition to the annual statement, and then the—

THE COURT: Well, this was then voted on, or something—

THE WITNESS: Yes.

THE COURT: Their proposal was voted on, and adopted by the overall—

THE WITNESS: Yes—and it—it was not adopted from them, it was recommended that they transfer it to the blanks committee for final adoption or voting it down, and they voted in favor of it, and presented it then to the—to the Executive Committee of the NAIC.

THE COURT: And, when did this presentation to the Executive Committee approximately occur?

THE WITNESS: In December—or in June of 1978.

THE COURT: All right. So, wouldn't it be fair to say then, it is my understanding, according to what you have just told me that that would be the first point in time at which the body as a body, as an institution, crystallized its thinking with respect to this situation, or expressed it, or—

THE WITNESS: Well, there was—apparently it had been—they had tried to crystallize it previously, by a single addition to the general interrogatories of the

[374] blank. Interrogatory number 3½, but that wasn't sufficient to meet what they felt was needed.

THE COURT: When did phase three,—when did interrogatory 3½ get put out?

THE WITNESS: It was—nearly as I could determine—

THE COURT: Roughly.

THE WITNESS: It went into—first it went into the blank about 1970.

THE COURT: All right.

MR. SCHWARZ: One moment, please.

(Pause.)

MR. SCHWARZ: May Mr. Grossman ask Mr. Sturtevant one or two questions before we finish?

THE COURT: All right.

BY MR. GROSSMAN: (Resuming)

Q Have you ever come in contact with a net unearned premium reserve on accident and health policies?

A No, I have not.

Q Can such a reserve be devised, sir?

A Ah—I don't believe it could. What we have available to work with. There have been very little of statistics which are dependab'e on anything except frequency of—of disablement duration and so forth, but the accident and health policy contains so [375] many different and sometimes the same—the same benefits, but modified a little bit here and there, and the premiums have been pretty much arbitrary, governed more by—by competition than by experience.

Q Sir, in the years that you have been involved in insurance, including the, approximately ten years of examining and auditing, have you ever—do you recall ever coming in contact with another agreement or treaty such as the 1957 agreement which purports to transmit premiums on what is referred to as an as earned basis rather than on an as written basis?

A No, I haven't. This—I look on this as a retrospective method of—of settling claims which doesn't involve reserves so much as it does a matter of experience.

Q And, do you recall ever seeing another agreement such as this?

A No, I haven't.

MR. GROSSMAN: I have no further questions.

THE COURT: Mr. Masinter?

CROSS EXAMINATION

BY MR. MASINTER:

Q Mr. Sturtevant, we have already established that prior to 1963 you knew absolutely nothing about Georgia law, Florida law or Arizona. Was the company that you worked for involved in credit life insurance?

[376] A Not at the time that I worked for them.

Q So, prior to 1960 you didn't know anything about credit life insurance?

A Well, I knew a lot about it from reading and so forth, but I—

Q Oh, reading where?

A In the—ah—various journals.

Q What journals?

A Well, the trade journals.

Q What trade journals?

A The—ah—National Underwriters—there is a half a dozen of them.

Q What did you—

MR. SCHWARZ: Would you please let Mr. Sturtevant answer the questions, fully?

BY MR. MASINTER: (Resuming)

Q When did you read them?

A Oh, for—I don't know, maybe back as far as 1950, I wouldn't be able to put a date on it. I also read a good deal in the actuarial journals.

Q Had you ever read a credit life insurance contract?

A Oh, yes.

Q You had.

A Yes, I have.

[377] Q In the course of your employment with your company you did that?

A No, in the course of my work with the insurance department.

Q What insurance department?

A The Georgia Insurance Department.

Q I'm talking about prior to 1960—

A Oh, I'm sorry.

Q Prior to 1960, had you ever read a credit life insurance contract?

A I don't believe that I ever did.

Q Prior to 1960 had you ever read a credit accident and health insurance contract?

A No, I think not.

Q Were you familiar with either a credit life or a credit accident and health insurance contract prior to 1960?

A Ah—not from—not from personal experience.

Q Prior to 1960 had you ever seen or read a reinsurance agreement between—in connection with credit life or credit accident and health insurance?

A Ah—probably not.

Q Now, in connection with your special consulting work, during the period 1960, 1961 and 1962 before coming to Georgia, did any of these companies that you did special [378] consulting work engage in the business of writing credit life insurance?

A Yes.

Q How many of them?

A One company in particular did a great deal of it.

Q Did a great deal?

A Yes.

Q Now, what type of credit life insurance did it issue?

A Issued credit life insurance primarily on automobile sales. These were financing of automobiles through industrial loan companies.

Q Now, how about credit accident and health?

A The same thing.

Q Did it also—

A Yes.

Q In connection with your experience during those two years did you have an opportunity to review any reinsurance agreements?

A Yes, I did.

Q Involving credit life and credit accident and health?

A Ah—

Q With whom were those reinsurance agreements?

A Ah—let's see, I'm trying to think of the names [379] of the companies—ah—I believe—I can't think of —I can't think of the names of them, but I know that there was one company in Providence, Rhode Island that wrote a lot of this business. There was one company in Chicago, Old Republic Life—

Q Old Republic?

A Yes, it did a lot of that reinsurance.

Q And, did you read any contracts of Old Republic?

A Yes, I did—I'm sure that I did. I read the contracts that this particular company had.

Q And, so in 1961, and 1962, is that approximately admitted, that it was your first exposure to a reinsurance agreement, how many of them would you say that you read?

A Oh, well, probably seven or eight.

Q Seven or eight. And, prior to that you really had never seen one?

A That's right.

(Pause.)

Q Now, Mr. Sturtevant, you just spent a long time testifying that the Georgia Department wouldn't have allowed the type of treatment that the Plaintiff took in connection with these reserves and so on—

MR. SCHWARZ: I don't believe that that was his testimony.

[380] THE COURT: Well, now wait, I think you better refine it a little more, wasn't it only with respect to this Exhibit 3 transaction?

MR. MASINTER: Well, I think that's what—

BY MR. MASINTER: (Resuming)

Q In other words with respect to the second treaty where Consumer Life Insurance Company wrote credit life insurance, and reinsured a portion of it with American Bankers, are you familiar with that treaty?

A Yes, I have read it.

Q You have read that, and that treaty began in 1962, is that not correct?

A I don't remember the date.

Q Now, you testified, I believe, that it would be the policy, or is the policy of the State of Georgia not to permit credit being taken for that reserve? Is that what you said?

A I said that the State of Georgia would not let them take credit for the reserve because they wouldn't regard it as a true reinsurance contract.

Q I see. Now, Mr. Sturtevant, let's—you get straight with this Court, isn't it a fact that the State of Georgia has continually allowed this credit?

A It has allowed it, unwittingly—

Q Until today, is that your answer?

[381] A Oh, no, no, we've—we've disallowed that on previous—

Q Since when?

A Well, we disallowed it in the case of—

Q I'm talking about in the case of Consumer Life?

A Oh—

MR. GROSSMAN: Your Honor, I wish he would permit the witness to answer the questions, and not stand there and just badger him.

THE WITNESS: Our—our relation with Consumer Life Insurance Company is not the same as it would have been with one of our domestic companies.

BY MR. MASINTER: (Resuming)

Q Oh, what is the relationship with Consumer?

A It is a foreign company.

Q And, as a foreign company, does it have to follow reporting in the State of Georgia?

A It does.

Q Oh, it does follow reporting. Does it do business in the State of Georgia?

A A great deal of business.

Q And, did you examine the report of the State of Georgia?

A We do.

Q Now, let's get back to this specific case of [382] Consumer Life Insurance Company, was it your testimony

that the State of Georgia would not have permitted this credit to be taken?

A That's right, had we known the facts?

Q Had you known what facts?

A The facts—of how it was being carried.

Q But, don't you have an opportunity to examine each and every annual report, and don't you in fact conduct an examination?

A The examinaion report doesn't bring this out, and as a matter of fact we have not conducted an examination of Consumer Life, we have left that to its home state.

Q Does Consumer Life file an annual report with you—with the State of Georgia?

A Yes.

Q And, don't you in fact participate in examinations of Consumer Life—

A We haven't, no.

Q You have not?

A No.

Q Never?

A We may at some time, but not while I have been chief examiner.

Q Since February of 1963?

A I became the chief examiner about sometime in [383] 1966, I believe.

Q All right. Now, how about American Bankers, does American Bankers file reports with the State of Georgia?

A Yes.

Q Does the State of Georgia examine American Bankers?

A Yes. We have participated in the examinations, of American Bankers.

Q I see. Is this reinsurance reflected in American Bankers reports?

A Not to my knowledge.

Q Not to your knowledge. So, what you are saying here, Mr. Sturtevant, is that you got a policy, but in fact, the facts are in this case, that that policy is totally contrary to your testimony, isn't it?

A No, I—

MR. GROSSMAN: Objection, Your Honor, I don't believe that that is a fair conclusion about anything that has been said here.

BY MR. MASINTER: (Resuming)

Q Now, Mr. Robinson, —excuse me, Mr. Sturtevant, I want to show you what has been marked as Plaintiff's Exhibit number 11, it says report of an examination of Consumer Life Insurance Company of Phoenix, Arizona, as [384] of December 31, 1963, prepared by Tom Robinson, Senior Examiner. Now, I call your attention to page 26, would you tell us what that says about the accident and health reserve?

A Ah—December 31, 1963, the aggregate reserve for accident and health policies was computed to be $65,613.00. Close review of the methods used to arrive this amount and a review of the amount arrived at showed the reserve to be adequate.

Q All right. Now, that says a close review, doesn't it?

A Right.

Q That would mean that somebody looked at it?

A This is the examiner's words.

Q All right. Now, how about page 24 with regard to accident and health insurance?

A Accident and health—accident and health premiums due and unpaid, verification of life insurance premiums uncollected was made at the same time as the reserve and life policies were valued. Accident and health premiums due and unpaid were verified by reviewing subsequent payments received by the companies.

Q Okay. Now, let's turn to page number 19 here, that reflects accident and health reserves, isn't that correct?

[385] A Aggregate reserves for accident and health policies, yes, that's the same figure that was in there that I read.

Q All right, the same figure.

A Um-huh.

THE COURT: Is it any part of Plaintiff's reporting obligations to the State of Georgia that it submit—its reinsurance treaties?

THE WITNESS: No, we depend upon the examiner to determine what—what those treaties are, and if there

is anything in there which would be in conflict with Georgia regulations, why it would be called to our attention.

THE COURT: And, what you are telling us is, that it would be your understanding that had the Commissioner known of the Plaintiff's 3, it would not have approved this reserve treaty, is that what you are saying?

THE WITNESS: Ah—it would not have—I'm saying that so far as the present administration is concerned, what would have been done before—when is this, this is as of 1963 when was this question—

BY MR. MASINTER: (Resuming)

Q That's when you were the chief?

A No, I was the actuary, but I wasn't the chief examiner then.

[386] Q Oh, I see.

THE COURT: 1966, he said he became chief.

THE WITNESS: I wasn't the chief examiner until 1966. I was actuary.

BY MR. MASINTER: (Resuming)

Q So, in other words you don't include the period while you were chief examiner as what—oh, excuse me, chief actuary as what the department would have done?

A No, that's up to the Commissioner and the chief examiner.

Q Oh, I see. So, in other words your testimony is only with regard to years 1966 forward, as to what—

A As to what the policy is with regard to—to—ah—this sort of thing here. Now, actually this—

Q Well,—

THE COURT: Let him finish, Mr. Masinter.

THE WITNESS: This report relates nothing of an adverse nature, nothing which we would criticize.

BY MR. MASINTER: (Resuming)

Q I see. Are you familiar with what the policy was prior to 1966?

A Ah—I—to the extent that I was engaged in audit of companies, and examination of their annual [387]

statements. I read the examination reports on life insurance companies, and if I saw aything in there that I thought deserved some special attention, I would call it to the chief examiner's attention.

THE COURT: But, that isn't what he asked you, Mr. Sturtevant. He asked you what your familiarity was with the commission policy prior to your becoming chief examiner in 1966?

THE WITNESS: Well, I can say—I can answer that in a general way, by saying that the man who was then Commissioner, Jimmy Bentley, was very meticulous about having everything done in accordance with NAIC regulation, and recommendations.

BY MR. MASINTER: (Resuming)

Q But, you are not personally familiar with what the policy of the department was?

A I was not—I wasn't personally involved in it to that extent.

Q Well,—I see. Well, let me ask you this then, Mr. Sturtevant, if we take this annual report, of 1962, now, I presume that this report would be filed with the Georgia Department, would it not?

A Um-huh.

Q Now, on Schedule S, I think that that is the one—schedule—ah—it says showing accident and health [388] reinsurance premiums ceded as of December 31st, 1962—

A Um-huh.

Q And, it shows American Bankers Life Insurance Company of Florida—

A Right.

Q Isn't that correct?

A Um-huh.

Q And, it shows premiums in force, it says 80 percent equals $320,454.12, now how do you interpret that?

A That was the total premiums in force on 80 percent of the business that they had written. In other words they took—they took 80 percent of their premiums in force, which had been shown on the schedule of accident and health premiums, and then extended over here at 80 percent—I don't know what that means, but—that isn't

80 percent at all. Oh, I think that they were figuring commission there probably.

Q So, what is your interpretation of that?

A I don't know how to interpret this right here, this unearned premiums estimated—oh, yes, I see. They estimated the unearned premiums as being 75 percent—they say 75 equals 80 percent. Wait a minute—this is dollars and cents—

MR. SCHWARZ: Mr. Masinter, could you refer me to what you are showing the witness, please?

[389] MR. MASINTER: It is Plaintiff's Exhibit number 9F, and number—

THE WITNESS: That is the only estimated unearned premiums that they took credit for, I assumed that's their total reserves.

BY MR. MASINTER: (Resuming)

Q I see. Now, this is the annual report, and—for 1963 or 1962,—1962, isn't that right?

A 1962, yes.

Q Um-huh. So,—so that shows that this annual report took credit for that reinsurance with American Bankers, is that right?

A Right, um-huh.

Q Now, let's look on 1963, and see what—what happened on that Schedule S. Now, tell us what that is?

A Well, they show $364,350.00 premiums in force. They say that the unearned premium on that was $270,-889.97, and 80 percent of that is $218,311.97, and this is presumably what they took credit for—the reserves.

Q All right, now, where were these annual reports filed?

A Ah—they were filed with every state in which they were licensed, I assume.

Q So, certainly in Arizona, if they were—

A Oh, yes, Arizona, certainly.

[390] Q And, Georgia certainly?

A Yes, sir, certainly.

Q All right. So, Georgia was aware of this credit taken for the reinsurance, isn't that correct?

A Um-huh.

Q Would they normally have filed a copy of the reinsurance agreement with this?

A No.

Q They would not?

A No.

Q All right. Now, how then, is this examination conducted?

A The examination is conducted by—in a manner to verify the fact that the company—whether or not the company has—has reported its financials to the various states honestly, in accordance with their records, and —that—of course, the ultimate result being it is general ledger of their solvency.

Q I see. Now, are you familiar with Mr. Robinson the examiner?

A I have met Mr. Robinson, yesterday.

Q Was he an employee of the Department of Arizona?

A He was, yes, he was an examiner for the Arizona Department.

Q I see. Did he—was he one of these contract [391] examiners too, do you know?

A I—I don't know.

Q Did he ever do any work for the Georgia Department?

A Yes, he is working for the Georgia Department right now, as I understand.

Q Has he ever done work before for the Georgia Department?

A Well, I think so.

Q So presumably he would be aware of the policy of the Georgia Department, as well as the Arizona Department?

A Yes, um-huh.

Q Now, he didn't mention anything about this particular contract as being in violation of the Arizona law, did he?

A No.

Q And, in fact he approved it, didn't he?

MR. GROSSMAN: Your Honor, I'm going to object to these questions. If—if the opposing counsel has any questions of Mr. Robinson, I think he ought to direct

them to Mr. Robinson. I don't think that it is proper for him to cross examine this witness about what Mr. Robinson thought about anything. If—if what the witness—

MR. MASINTER: Well, I'm directing him to the [392] report.

MR. GROSSMAN: If what the witness—if he is asking for questions—for answers that are apparent on the face of the document, I suggest that he can refer to the document itself, and not badger the witness with unnecessary questions.

THE COURT: Overruled.

BY MR. MASINTER: (Resuming)

Q The report for 1964 also, Mr. Sturtevant, I want to refer you to Schedule S, and ask you—

MR. SCHWARZ: Is that 9F, Mr. Masinter?

MR. MASINTER: Yes, it is.

BY MR. MASINTER: (Resuming)

Q Schedule S,—you will forgive me for mumbling, but I have never seen one of these before.

A That's all right.

Q Now, let's see the schedule—is that right?

A Policies—no, this is policies assumed by reinsurance.

Q Okay. Where is Schedule S—

A Let's see Schedule S is in several sections—

Q Schedule S—

THE REPORTER: Excuse me, if you overlap with your voices—if—

THE WITNESS: Oh, thank you.

[393] BY MR. MASINTER: (Resuming)

Q All right—all right, now Schedule S—let's see, what does that say about accident and health reinsurance?

A Well, these amounts receivable—this is Schedule S, part II, showing accident and health reinsurance premiums ceded as of December 31st, current year, American Bankers of Miami, Florida, $535,295.58 premiums in force; unearned premiums $244,500.95.

Q I see. Now, I'm sorry that I misunderstood your testimony before, I understood you to say that you were familiar with the policy for the period prior to 1966?

A Right.

Q But, as I understand now, you were not familiar with the actual policy of that administration at that time?

A No, I wasn't familiar with the policies for the administration before 1963. And 1963 was when the administration came in that I was with.

Q I see. But, you were familiar with the policy in 1963 and 1964, is that correct?

A Right.

Q And, in 1963—1962, 1963 and 1964, Consumer Life Insurance Company filed annual reports with your [394] department, isn't that correct?

A Yes.

Q And, in each and every case, those Schedules reflected reinsurance ceded, isn't that correct—

A Right.

Q To American Bankers, and the Georgia Department did not raise any question, did it, with respect to that reinsurance, is that correct?

A That's true.

Q And, the Georgia Department also was privileged to receive a copy of a report of examination conducted by the Department of Insurance of the State of Arizona?

A Yes.

Q It did receive it, and in that report no question was ever raised about this reinsurance was there?

A No, it wasn't.

Q So, actually then, what you now say, is the policy, —or was the policy at that time, does not conform with the results of this report, does it?

A No—

MR. GROSSMAN: Objection, Your Honor, that's an improper conclusion of—

THE COURT: Overruled, no it is not an improper —it is a perfectly permissible inference,—overruled.

MR. GROSSMAN: Your Honor, may I elaborate on [395] that?

THE COURT: You can be heard, go ahead.

MR. GROSSMAN: I believe that the witness has testified at length that unwittingly the—

THE COURT: All right, maybe unwittingly or for some other reason, the question was in terms of end result—end result as reflected by the referenced Exhibits, does that square with the witness's understanding of the implementation of the policy as he conceives it, and the answer is no.

MR. GROSSMAN: Oh, I thought the implication—I thought that the conclusion was to the effect that they had all the relevant information, and came out with the result that was contrary to the policy, if that it not the conclusion that was stated, I withdraw my objection. I think that the witness has very clearly made it known that they did not have the relevant treaties in their possession and did not refer to it, and that would—

THE COURT: He has made it known, like he so testified, and we don't need to be reminded of that.

BY MR. MASINTER: (Resuming)

Q Now, in this administration, prior to the time that you came there, were you familiar with the reports that had been filed by Consumer?

A No.

[396] Q Okay. Well, then let me show you then Plaintiff's Exhibits 9A, 9B, 9C—

MR. SCHWARZ: Excuse me, I would like to hear a repeat of the question, I'm sorry, I wasn't paying attention.

(Whereupon, the Reporter played back the question as requested.)

BY MR. MASINTER: (Resuming)

Q I show you then, reports—or Exhibits 9A through E, which is the annual statements of Consumer, 1957, 1958, 1959, 1960, and 1961. Now, would you tell us what these reports show, with regard to its reinsurance treaties with American Bankers?

A Ah—it shows no accident and health—this is the report for 1957, shows no accident and health reinsurance

premiums ceded. It shows nothing of any transactions with American Bankers.

Q Well, that is correct, it shows no transactions, does it?

A No.

Q And, the reason is that it did not report the accident and health reserves in its reserves. However, I show you American Bankers schedule, and its Schedule S, for 1958, and 1959, and 1960, and would you tell us if it reports that it ceded anything to—to Consumer Life [397] Insurance Company?

A Let's see—here's accident—no, that's losses—ah—this is it. There is nothing on—here's insurance ceded to 20th Century Life Insurance Company.

Q 20th, but not Consumer, is that correct?

A That's correct.

Q Okay, now, how about for 1959?

A 1959, there are three companies, Falcon Life, 20th Century and Diamond State.

Q But not Consumers?

A No.

Q All right. Now, how about 1960?

A Ah—there is Falcon, Thunderbird, Southern, First RG Life, and Diamond State Life.

Q All right, now, but not Consumer again, is that correct?

A Right.

Q Now, would those reports have been filed within the State of Georgia?

A Oh, yes, they should have been.

Q They should have been, because American Bankers was writing insurance—

A They were licensed there.

Q At that time in the State of Georgia?

A I'm quite sure—

[398] Q Now, I presume then, that the State of Georgia would have participated in the examination of American Bankers?

A It has participated in—in examining American Bankers, I'm not sure whether they did during that period or not.

Q Well, it says—
A The examination report would show it.
Q Where would it show it?
A The signature is at the back.
Q I see. But here's participation, doesn't it show Georgia on there—on the report?
A Yes, it does, it shows Georgia.
Q It sure does, doesn't it?
A Um-huh.
Q Now, let's see what that report of examination participated in by the State of Georgia said with respect to that reinsurance?

THE COURT: That being Exhibit—what?

MR. MASINTER: I'm sorry, that's Exhibit—let me see on the front—18.

THE WITNESS: This is as of December 31st—

MR. SCHWARZ: Your Honor, could we see that before he comments, we don't have a copy of that Exhibit?

THE WITNESS: 1960—this is for 1960.

[399] THE COURT: Just hold up for a moment, Mr. Sturtevant.

THE WITNESS: Um-huh.

THE COURT: You weren't supplied copies of it?

MR. SCHWARZ: No, we weren't, we discussed it earlier—

MR. MASINTER: This was what we discussed.

THE COURT: We'll take a ten minute recess.

(Whereupon, the hearing in the above was recessed at 2:22 as described above.)

[400] THE COURT: Counsel ready?

MR. MASINTER: Ready, Your Honor.

BY MR. MASINTER: (Resuming)

Q Now, Mr. Sturtevant, we were looking at Plaintiff's Exhibit 18, I believe it was, which is the report on examination. Now, this is the report on examination of American Bankers and the date of that is as of December 31, 1960, is that correct?
A Right.
Q So presumably the examiner or group of examiners have looked at these reinsurance agreements between American Bankers and Consumers, isn't that correct?

A Yes.
Q And Georgia did participate in that examination?
A Yes, Georgia did.
Q Now, would you tell us what their results of their findings with respect to the reinsurance agreements were?
A Company had in force 14 reinsurance agreements. The domestic companies providing from 70 percent to 100 percent cessions, a certain credit life and credit A and H business. On 100 percent cessions, the company received commissions varying from ten percent to 67 and ½ percent contingent upon services rendered. Nine companies not having sufficient capital or surplus or a [401] combination of both, to meet the statutory requirement for companies admitted to do business in the State of Florida where rule is unauthorized reinsurers by the insurance commissioner.

Such reinsurance premium reserves and balance is recoverable from accounts and claims due from these companies were therefore not admitted. The unauthorized companies are indicated by an asterik and so forth. Lists the companies by name, one of them being the Consumers Life.
Q Consumers does not have an asterik.
A No, it doesn't.
Q So Consumer Life is listed without an asterik, isn't that correct?
A Right.
Q Now, that means it was an—
A It was an authorized company.
Q It was an authorized company and presumably the reserve for life insurance was permitted?
A Right.
Q Is any exception taken to the manner in which the accident and health insurance was treated?
A I am looking for a specific mention of accident and health. This is just with reference to the alien companies. There's no comment that I can find on the [402] reinsurance with the listed companies, with the domestic and foreign companies.

Q And according to your review of this examination no exception was taken, is that correct?

A Yes.

Q Now, Mr. Sturtevant, let me call your attention to—

A Excuse me just a minute, let me see under reinsurance balances payable, if there's anything in there.

Reinsurances balances payable of $25,000.00, they say this liability was determined by listing of all credit life reinsurance balances payable as of December 31, 1960. The credit balances were offset by debit balances. All accounts owed by the company were settled promptly after January 1, 1961. Unauthorized reinsurance balances are shown elsewhere. Ordinary reinsurance balances were offset against premiums due and uncollected. These premium balances were paid as billed January, February '61. This is all they have to say about it.

Q So, no exception is that correct?

A Right.

Q Now, I show you then Plaintiff's Exhibit #19 which purports to be—which is the report on the [403] examination of American Bankers as of December 31, 1963.

Now, as I understand you had been with the department—

A About a year then.

Q About a year? And the policy of the department at that time with your administration, is as you testified before, isn't that correct?

A Right.

Q Now, did Georgia participate in this examination?

A Yes, they did.

Q Would the State of Georgia been aware of the reinsurance agreements between American Bankers and Consumers for 1962 and 1963?

A Let's see what they said about it.

Q Well, let's answer that question first. Would the State of Georgia have been aware of the reinsurance agreements in effect between American Bankers and Consumers for 1961, '2 and '3 based on examination of both American Bankers and Consumers.

A No, the Georgia insurance department was not aware of the contents of those contracts because no comment had been made about them.

Q Well, I presume that with the State of Georgia participating in this examination of American Bankers, it would have had an opportunity to make an adverse [404] comment, wouldn't it?

A If the examiners had done so. Let's see if they did.

THE COURT: Well, are you telling us in the regular course of such an examination, the Georgia examiners would not have called for the subject reinsurance agreements?

THE WITNESS: Some examiner is supposed to—any examination is supposed to look over the reinsurance agreements. Now, it could have been a Georgia examiner. It could have been—there's four states—five zones involved here. These five different states represented on the examination. We don't know which one examined what.

THE COURT: But examination of all outstanding reinsurance agreements would be a checklist item.

THE WITNESS: It would, yes sir.

BY MR. MASINTER: (Resuming)

Q Now, would you take a look at this examination report and tell us, Mr. Sturtevant, if any exception was taken in the manner in which American Bankers treated the reserves in connection with the reinsurance agreement that's in Consumers?

A That's what I'm looking for here. Let's see. [405] Experience refunds due from reinsurers. Amounts recoverable from reinsurers. Credit life—I don't see any direct. This is a poorly drawn—

Q Why don't we start with the section dealing with reinsurance? Wouldn't it be most appropriate to note it there?

A Yes, but I don't—that's what I was looking for, but I don't find such a section.

Q Well, isn't there a section—

A There's credit life and accident and health, you see, I read that. That's got nothing to do with it.

Q Now, what does that say? Well, at the very beginning. Doesn't it say that there were treaties in existence between American Bankers and Consumers?

A Yes, Consumers is listed here.

Q Is listed, and no exception is taken in there at that point?

A I don't find any.

Q So presumably they would have permitted American Bankers to report the reserve with respect to the 80 percent portion that it reinsured, is that correct?

A The examiners didn't question it apparently.

Q So then your testimony before as to what the policy in 1963 was, does not conform with the result of [406] this examination, is that correct?

A I don't agree with that. We depend—we have to depend naturally upon the certification of the officers of the company in their annual statement and upon the reporting by the examiners in the case of an examination. Until we learn either accidentally or through an examiner that there are such contracts in existence, there's nothing we can tell about it.

Q Your examiner participated in this examination.

A Right.

Q You had every opportunity to examine it and impose your own views and policies?

A Our examiner may not have—

MR. SCHWARZ: I object, Your Honor. He's already testified with respect to the power of any particular examiner to review the entire audit.

THE COURT: Overruled. You may have redirect.

BY MR. MASINTER: (Resuming)

Q How many states participated in this examination?

A Five.

Q Five, now which ones—

A No, there's six. Four, I mean, there's Arizona, Arkansas, Georgia and Florida.

Q So the three states in which we are primarily concerned with, Arizona, Georgia, and Florida, participated [407] in this examination?

A Right.

Q Of the four doing the examination?

A Right.

Q So if any of those states would have had questions about this reinsurance, it would have been noted in this report, wouldn't it?

A I don't—

Q Not noted, is that correct.

THE COURT: Is this examination what you might call a field examination or is it what you would consider an office examination?

THE WITNESS: Primarily an office examination.

THE COURT: Do you understand what I mean by the two terms?

THE WITNESS: Yes, I assume you mean—

THE COURT: By office examination does this mean that this—

THE WITNESS: Oh, I see, no this is an examination made in the company's home office.

THE COURT: A field examination, in other words?

THE WITNESS: A field examination, yes sir.

BY MR. MASINTER: (Resuming)

Q And how long does the examination normally take, of a company like American Bankers?

[408] A Oh, six months, maybe, six months to a year.

Q Six months to a year?

A I would think.

Q Who pays for the examination?

A The insurance company.

Q You mean American Bankers would pay for it?

A Right.

Q What would be the amount that it would normally pay for these state examiners to come in and examine—just an estimate.

A What is that question?

Q What would be the amount that it would normally pay for the state examiners to come in to conduct this examination for six months or a year?

A Well, I don't know what it was at the time this examination was made but at present it would be $100.00 a day plus traveling expenses for each examiner.

Q For each examiner and each examiner would stay there for about six months to a year, so then it could run into many, many thousands of dollars?

A Oh yes, it does.

Q And probably 50 to $100,000.00 to conduct this examination, is that right.

A Let's see. The company with 10 and ½ million of assets, no that wouldn't take that long for [409] this company. I thought it was a much larger company than that. I don't know, maybe three months with four examiners.

Q Four examiners, but it's not a cursory review, is it?

A No, it isn't, it's a very thorough examination.

Q Let me ask just a few more questions, Mr. Sturtevant, about your testimony concerning the accounting principles on premiums that are to be received in the future. If a reinsurer assumed a risk and its contract providing that the premiums were to be paid in the future, I believe you testified that you would have to set up some sort of asset, in your opinion?

A Yes.

Q It wasn't done in this case, but—

A No, it wasn't.

Q —in your opinion it ought to be?

A That would be my opinion as to proper accounting.

Q Proper, would it be improper to reflect it any other way, in your opinion?

A I think it would be definitely improper because it wouldn't truly express the conditions of the contract.

Q Suppose the reinsurer took the assets for this—in other words, put the assets on its books, for the premiums that it was going to receive in the future. This [410] would then represent a premium paid in advance of a contract due date under our contract, wouldn't it?

A No, —well, your contract provides for the payment of premiums monthly. I think is actually a deferral of proportionate shares of the premiums.

Q Well, that's what I'm talking about—

A Rather than advance. You're not paying them an advance. You're deferring premiums due now.

Q I'm sorry, credited in advance of the contract due date, I thought was your terminology as to how the account ought to read, but that's why I used the term advance but under the contract, the premium is deferred. That's quite correct.

A Yes.

Q Paid on a monthly basis. Now, as to the ceding company, it would pay those premiums over on a monthly basis and you say now that the reinsurer should do what with those premiums it's going to receive in the future.

A The insurer should set up an asset, a non-ledger asset.

Q A non-ledger asset?

A A non-ledger asset.

Q What is a non-ledger asset?

[411] A It's an asset which does not appear on the company's books of account which are a debit/credit basis. This would be a single entry type of asset like deferred premiums on an ordinary insurance operation.

Q Would it have the effect of an asset that would be admitted?

A Oh yes, yes.

Q For the purposes of determining—

A Right, because it would be offset by certain liabilities, namely, commissions which would be due as each of those premiums was paid and reserves.

Q And reserves. So in other words what would the reserve reflect?

A The reserve would reflect the amount of the unearned premium.

Q What unearned premium?

A Unearned gross premium.

Q But they—

A This is only type of reserve we have.

Q But they don't have an asset called an unearned gross premium.

A I'm talking about liability.

Q Okay, on the liability side, you say there ought to be a reserve and I take it that the reserve is against the asset.

[412] A Right.

Q But we don't have an asset called unearned gross premium. We have an asset called—

A No, you have an asset called premiums in course of collection or deferred premiums or something of that sort.

Q I see. Not an advanced premium, as you said.

A No.

Q So it's a premium that's to be deferred in the future? Well, if it's a premium to be deferred in the future, how can it be an unearned premium?

A The premiums—all premiums are received or expected to be received are earned as time goes along, but they're unearned—in other words, everything in advance of the date in which you're making your valuation is an unearned premium.

Q So what you're saying is if one company holds the premium and another company has the right to receive them on a monthly basis, that you still have an unearned premium on the books of both companies books.

A No, you have an unearned premium on the books of the reinsurer.

Q And not on the books of the company that holds the premium?

What does the company that holds the premium [413] do with it, show nothing?

A Yes, they'd show a liability of the insurance premiums owed.

Q How does it reflect the asset?

A The asset they would have would be the commission that they'd get back on that.

Q Well, if it's—

A In other words, if they got a three percent commission, they'd show a liability of a dollar and an asset of 30 cents.

Q I see, but how does it reflect the whole premium that it holds, irrespective of the three percent? Wouldn't you say it's an asset in its hands?

THE COURT: Well, in this instance, the asset would be the money they got from the policy.

THE WITNESS: It holds cash, which is an asset, which it owes to the reinsurer and that's a liability, so it's an offset.

BY MR. MASINTER: (Resuming)

Q So you say it's got cash and not unearned premiums?

A Right.

Q And it's got a liability on the other side?

A Right.

Q Now, let me ask you this again, Mr. Sturtevant. [414] Again, have you ever seen a policy like this before, either the first policy or the second policy?

A You're talking about a policy—

Q Excuse me, a reinsurance premium.

A A contract where the reinsurer does not carry the reserves, but gets the premiums a month at a time.

Q Have you ever seen a reinsurance treaty such as the two that you say that you've examined here?

A I've seen lots of reinsurance treaties on the surplus aid type but never one where the ceding company retained the reserve.

Q So that this is your first exposure to this type of policy.

THE COURT: Excuse me, I guess I didn't understand this. I haven't seen these treaties, but I was under the impression that the treaties, Plaintiff's 2 and Plaintiff's 3 were silent as to who was going to hold the reserves. Do they specify in here—I see.

MR. GROSSMAN: Your Honor, I'm not sure that's correct. I believe Your Honor was correct inasfar as the specification goes. The particular clauses were read to the Court yesterday and there was some doubt as to what they actually meant.

THE COURT: All right, well, they'll speak for [415] themselves. I just didn't recall.

MR. MASINTER: I think they do, but if they don't we'll correct it on brief or whatever.

BY MR. MASINTER: (Resuming)

Q So then in the experience of the examining companies in the last ten years, I take it that you have examined a lot of credit life companies?

A We have.

Q How many have you personally participated in?
A I personally participated oh, probably in about 15 or 20.
Q And never seen a contract like this one?
A No.
Q So this is really the first time that you ever had an opportunity to form an opinion as to the correct accounting treatment and reserve treatment as to this question today?
A Yes, this is the first time I ever applied accounting principles to this particular type of thing.
Q You have no prior experience with regard to these types of contracts?
A No.
MR. MASINTER: I have no further questions of the witness.
THE COURT: Redirect.
[416] MR. SCHWARZ: Your Honor, could we have about two minutes?

(Discussion off the record)

MR. SCHWARZ: Your Honor, we have no further questions.
THE COURT: Thank you, Mr. Sturtevant, you may be excused. Do you have a witness, Mr. Schwarz?
MR. SCHWARZ: Yes. Mr. Tom Robinson to the stand.
THE COURT: Raise your right hand. Do you solemnly swear that the testimony you are about to receive will be the truth, the whole truth and nothing but the truth, so help you God.
MR. ROBINSON: I do.
THE COURT: Please be seated.
THE REPORTER: Would you state your name and address please for the record?
THE WITNESS: Tom Robinson, 1304 Waco Street, Gatesville, Texas.

TOM ROBINSON, a witness produced on behalf of the Defendant, having been first duly sworn, by said Trial Judge, was examined, and in answer to interrogatories, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARZ:

[417] Q What is your present occupation?
A I am an examiner, participating in an examination of a company in Washington, D. C. for the National Association of Insurance Commissioners.
Q Are you employed?
A No, I am not. I'm representing zone 3.
Q Are you a title consultant or are you just retained by the NAIC in connection with the examination.
A I am retained by the State of Georgia with an accreditation of my credentials to the examination from National Association of Insurance Commissioners.
Q Would you state, Mr. Robinson, the educational background you had, college—
A Yes sir, I am a high school graduate. I attended Baylor University—Independence College, Baylor University and after World War II the University of Texas and I completed my required work for Bachelor of Science degree in 1947.
Q Did you study insurance in your work for that degree?
A Excuse me?
Q Did you study insurance in your work for that degree?
A Well, my major was mathematics and my minor was foreign languages.
[418] Q I see.
A So by trade at that time I considered myself to be a mathematician.
Q When did you get your first experience in the insurance industry?
A I went directly from the University of Texas in 1947 as an assistant to an assistant Attorney General of Texas engaged in compiling the first codification of

the Texas insurance laws. At the same time cross referencing all the Attorney General's opinion rendered on the subject to that date.

Q How long did you pursue this?

A I was there two years.

Q Until what year?

A Excuse me?

Q Until what year?

A 1947 to 1949.

Q And thereafter what work did you do?

A 1949 I went to the Texas Insurance Department as an examiner and from 1949 to 1957 I progressed to senior examiner, assistant chief examiner and chief examiner.

Q In the course of that work, was it necessary for you to familiarize yourself with the Texas insurance code?

[419] A Yes.

Q This is the same code from which you were working from 1947 to '49?

A Well there were two additional codifications that came about after the first one, but I considered myself at that time to be reasonably—have a reasonable knowledge of all of the codes.

Q Did you also familiarize yourself with insurance and actuarial principles generally applied in this country, in the course of that work?

A My claim to whatever competence I have in actuary came about entirely through my experience in the insurance departments and in companies doing the work.

Q I see. Do you recall as senior examiner of the Texas insurance—approximately how many companies filed reports with the State of Texas?

A No, I don't recall how many reports with the State of Texas, but over the length of my time as an examiner, I participated in eight or 900 or more.

Q What did you do after 1957?

A 1957 I left the Texas Insurance Department and went with a European combine of reinsurers and stayed there until 1964.

Q And in the course of that work, what did you do?

[420] A I was engaged solely in the insurance business.

Q What aspect of that business did you involve yourself on a day to day basis?

A Both life and casualty.

Q What kind of work did you do? Were you doing selling work or actuarial work or administrative work?

A My assignment consisted of conducting the business of three of the companies in that group, being responsible for it.

Q For all the business of the companies?

A Yes sir.

Q And all the aspects of that business?

A That's right.

Q I see. And from 1964 onward, what was your capacity?

A I came back to Phoenix, Arizona in order to enroll my daughters in Arizona State University and while there I did work for the Arizona Insurance Department. Some as a senior examiner. At a later time going on to deputy director and acting director.

Q Are you—do you recollect serving as the senior examiner in connection with the conduct of the audit examination of the Consumer Life Insurance Company?

A If looking back ten years will permit me, I'm familiar with it.

[421] Q I show you Plaintiff's Exhibit 11 and ask you whether this is the report of the audit examination you conducted?

A That is the audit and examination I conducted.

Q Have you reviewed that report recently, to refresh your recollection?

A I made a cursory examination of it at the time I was handed it before this. Unfortunately, I don't have in hand the working papers that resulted in this report and I will be handicapped with respect to questions as to any part of it by the ten year period. Had I the work sheets, I would be able to go into those matters in detail.

Q Do you know how long those work papers are kept by the—

A They're generally kept until the next examination has been conducted and posted. Then they're destroyed.

Q How often are these examinations conducted?

A Well, the statutory period in Arizona, as I recall it was three years.

Q That would have been—

A Sometimes the shortage of examiners didn't enable the director of insurance to keep to that schedule.

Q I see. Have you reviewed the Plaintiff's Exhibits 2 and 3, the reinsurance contracts that issue [422] in this case?

A I didn't hear your question. You'll have to speak up a little bit.

Q Have you had an opportunity to review the reinsurance treaties which are Plaintiff's Exhibits 2 and 3, that have been involved in this case?

A I have had a chance to examine them.

Q And have you reviewed the annual statements which were filed by Consumers for the years covered by that examination?

A I have.

Q Has that—

A Although not with the same intensity as the examination report.

Q I see. And has that review permitted you to recollect some of the circumstances under which—

A I recollect as many as I'm able to recollect.

Q Now, the testimony here has been that the report of examination, Plaintiff's Exhibit 11 did not take any exception to the treatment of unearned premium reserves as far as Consumer was concerned, is that your understanding of the reading of the report?

A Are you speaking with respect to the reinsurance transaction?

Q Yes, I am.

[423] A No, there isn't so far as I remember or from my cursory examination of this report which I made, any criticism with respect to that, but there is—

Q Mr. Robinson, I believe you've already answered my question. There was no criticism taken in that report.

A No.

Q Of the treatment. And do you recall that under the first of the two treaties, Consumer was the reinsurer and under the second of the treaties, it was the ceding company?

A That's correct.

Q Now, with respect to the second treaty, do you recognize that as being a form of surplus aid contract as you understand the term?

A I do.

Q I didn't hear your answer, sir?

A I do.

MR. MASINTER: If Your Honor please, I'd like for the witness to identify what he means by surplus aid contract because that could have any number of definitions.

THE COURT: I think that's proper. Develop that, will you, Mr. Schwarz?

BY MR. SCHWARZ: (Resuming)

Q Mr. Robinson, can you tell us in what sense the [424] Plaintiff's Exhibit #3 was considered by you to be a surplus aid contract?

A Now, the term surplus aid, I mean that by—

MR. MASINTER: If Your Honor please—

THE COURT: Well, he's going to give the right answer but the question ought to be what is a surplus aid contract in his ken and then proceed from there.

MR. SCHWARZ: May I withdraw my question and substitute?

THE COURT: Yes, right.

MR. SCHWARZ: The proper question.

BY MR. SCHWARZ: (Resuming)

Q Mr. Robinson, what is the surplus aid contract as you understand it?

A I know a surplus aid contract to be a contract the execution of which enhances one of the party's surplus. One of the party's to the contract surplus.

Q Do you consider the Plaintiff's Exhibit #3 to be a surplus aid contract?

A I do.

Q Now, will you describe how that contract—let me ask you first, whose surplus is aided by that contract? Is it the surplus of Consumer, the ceding company or the surplus of American Bankers, the reinsurance.

A Are you speaking of 1962 treaty?

[425] Q Yes, I am.

A The 1962 treaty, my opinion is, that the surplus of the Consumer Life Insurance Company is enhanced by the agreement.

Q And would you explain how the agreement serves Consumer as a surplus aid?

A If I might, I'd like to have a copy of that agreement.

Q Of the treaty?

A Yes.

Q Certainly. I hand you Plaintiff's Exhibit 3 and ask you, is this the 1962 reinsurance contract that you're referring to?

A That is correct. This is it.

Q Would you tell the Court how that contract serves the ceding company, Consumer as a surplus aid contract?

A Shall I tell it in my own words?

Q Certainly.

A I recognize this contract, at the time that this—at least I recognized a contract at the time I conducted the examination as a surplus aid contract. I conducted the examination of the Consumer Life Insurance Company and at the time that I completed the examination I took the rough copy of the examination plus the working [426] papers back to Phoenix, Arizona to discuss the matter of this treaty with the then director of insurance, Mr. George Bisnell and I had analyzed it in his presence and the 1962 agreement under this agreement, I told him the Consumer Life Insurance Company pays to the reinsurer—that's American Bankers—the gross reinsurance premiums less 50 percent commission or a net of 50 percent as the losses are determined, they are paid by the American Bankers until Consumer Life has received back from American Bankers the losses recovered in an aggregate of an amount equal to 47 percent. That would be the 50 percent less the three percent which is referred to in the contract as being retained by the reinsurer.

That is, three percent of the earned reinsurance premiums. Additional losses are charged back to Consumer Life under this agreement, in my opinion, on a basis of one to one. In my opinion, the ultimate affect on Consumer Life is that it has a loss of three percent of its ceded premiums. That Consumer Life, in my opinion, actually carries its own full risk throughout the entire period of the agreement, with respect to its gross business. That is my analysis of the agreement.

After I made this presentation to Mr. Bisnell—

Q Let me just ask you, Mr. Robinson, just to [427] interrupt for one moment, how did that particular arrangement serve as a surplus aid contract to Consumer?

A Well, it served as a surplus aid for the reason that it purports to relieve itself of 80 percent of the liability of unearned premiums, when in fact no risk passes so no unearned premiums, it would seem to me, are entitled to be established by the American Bankers Assurance Company.

Q Would you continue as you were before?

A After I had made this analysis to Mr. Bushnell, he of course had many questions. It was my impression at the time that this is the first time that Mr. Bushnell was aware that this would be a particular problem in Arizona because to my best knowledge at that time, Arizona was the only state that permitted the organization of life insurance companies with such a low capital and surplus. I do not know how many were organized but dozens of them, so that to some extent this was a new problem to Mr. Bushnell and to the department. I do not believe at the time that I took this into Bushnell, the department had any policy whatsoever with respect to this kind of agreement.

Q And what was the response of Mr. Bushnell?

A Well, Mr. Bushnell of course hesitated to make any sort of a judgement with respect to this contract [428] on the basis of the one contract.

Q Was he understanding that within the Arizona insurance code that was being applied at the time, that Mr. Bushnell had the discretion to either allow the credit or not as he saw fit?

A I searched the statute book myself and I could find nothing on it and that is the reason that the problem was carried to the director himself.

Q Go ahead.

A His explanation to me in addition to the fact that he would want to know more about how many of this kind of agreements existed, was that first the one I enumerated, that he wouldn't want to make a judgment on the basis of the one agreement and secondly that he had acquiesced or at least the department had acquiesced although unknowingly, if other agreements of this kind existed. So his further plans were, he told me that he was aware that there was to be an examination made of the American Bankers Assurance Company in almost the immediate future and it was his plan then to put me on that examination to see whether or not the State of Florida was permitting this kind of agreement to be made by American Bankers and whether or not, and what the treatment of the State of Florida was with respect to this. In addition I was to do some [429] special work on American Bankers and try to ascertain how many other of this type agreements they had with respect to Arizona companies.

Q Did you feel that because 80 percent of the unearned premium reserve on this business was not reflected on the annual statements of Consumer, that that statement did not reflect adequately the insurance business that Consumer was conducting?

A That was my conclusion brought about by the statement that I made that the ultimate effect of that agreement was that the Consumer Life Insurance Company lost three percent of its ceded premiums all the while bearing the gross risk because in no case under this agreement could American Bankers under the provisions that we have discussed make more than three percent of the ceded premiums.

Q Before you go on, let me just ask you one other thing about the first treaty involved in this case. Do you recall that treaty? Are you familiar with the treaty dated 1957?

A I am familiar with the treaty.

Q And are you aware that under that treaty American Bankers was the ceding company and Consumer was the reinsurer?

A In the parlance of business we call that a [430] fronting treaty and it has that name because the company, the reinsurer, the Consumers Life Insurance Company could not legally write this business and reinsure it in American Bankers or any other company, so for this three percent which evidently is the ultimate compensation as a result of this contract, American Bankers wrote the business and reinsured it in Consumer Life which amounted to doing indirectly what you could not legally do directly.

Q Mr. Robinson, I show you Plaintiff's Exhibit 2 and ask you whether this is the 1957 reinsurance agreement between American Bankers and Consumer Life.

A That is the agreement.

Q Would you state for the Court your understanding of what the reinsurance premium is in that treaty?

A This is the agreement where all of the business was written in American Bankers and ceded 100 percent to Consumer.

Q What was the fee that was retained by American Bankers under that agreement for its services?

A 87 and ½ percent.

Q I am referring to the amount that was ultimately retained by American Bankers, not the amount that was remitted to the reinsurer. I believe the 87 and ½ percent—

[431] A You mean the ultimate result of this?

Q Yes.

A The ultimate result of this agreement is the same as the other one.

Q But the fee is different in this agreement and I just want to verify that you said three percent, but the fee here is 12 and ½ percent, the difference between 87 and ½ and—

A That's correct.

Q I just wanted to clarify the percentage in this.

A Let me thumb on through this so I don't miss any of these provisions. One unusual aspect of these agree-

ments is if you can take this 1962 agreement and you can change the 80/20 participation to 90/10 or 50/50 or 60/40 and the ultimate results of the agreement is that the Consumer Life is paying three percent of its ceded premiums—

Q You are referring to—

A The adjustment of these figures with respect to the percentages do not affect the results of this agreement in any respect.

THE COURT: Referring to Plaintiff's 3, is that correct?

MR. SCHWARZ: Yes, that's correct, Your Honor.

[432] BY MR. SCHWARZ: (Resuming)

Q Mr. Robinson, you were telling us about your assignment as an examiner on the audit of American Bankers? Would you continue with that?

A Yes, I don't recall. I do recall receiving the assignment and going to Miami and being there the most part of a summer, and I do not recall the number of months, but three or four anyway. During the course of that examination I made this special examination of—with respect to the Arizona companies and with respect to these credit life contracts in general. After the examination had been underway a month or two perhaps, or maybe three because this has been ten years ago, I left the examination with a knowledge of the company and in fact charged to them the expense of an air trip back to Arizona to discuss this matter with the then director George Bushnell and after I had done that—

Q Excuse me, sir, by this matter, are you referring to the problems about how—

A I am referring to all of those things which I mentioned which included was was involvement of any Arizona insurance companies, what the State of Florida did with respect to the transaction of that kind of business by the reinsurer and what the state of Florida did with respect to any of its companies which entered [433] into agreements with an insurer. Those three things at least

and probably, if my memory would serve me better, more than that.

Q Go ahead, sir.

A I made this special report to Mr. Bushnell and added what comments I had to it and then flew back to American Bankers.

Q What was the report you made to Mr. Bushnell?

A I have already described as best I could ascertain what the policy with respect to this was to Arizona. I didn't think they had any policy with respect to it and as he said they had acquiesced in this, to the extent that it had already gone, knowingly or unknowingly. I found that respect to Florida, it evidently did permit that kind of an agreement to be made by companies domiciled in its—in the state. I do not recall—I do not believe that any of these limited capital stocks could have existed in Florida, at least that's my recollection, but so far as the American Bankers entering into these agreements, the Florida insurance department's policy as it was expressed to me by the examiner in charge and from my investigation of the files was that they did permit it.

Q Now, in this case is it correct that Florida would be evaluating the unearned premium reserve which [434] American Bankers showed on its books for this so-called 80 percent of the unearned premiums that was reinsured from Consumer, is that right?

A Well, it's been too long for me to remember or retain that kind of figure, but whatever American Bankers did with respect to this contract, according to the examiner in charge of the examination which I believe was Mr. Melvin Courson, as I recall his name, the Florida department took no exception to it when we went to draw the report on the examination.

Q I see.

MR. SCHWARZ: May we have a minute, Your Honor. I have no further questions of the witness.

THE COURT: Cross?

CROSS EXAMINATION

BY MR. MASINTER:

Q Mr. Robinson, tell us what the result was of all this great hurrah that you made out of this reinsurance agreement?

A You—

MR. GROSSMAN: Your Honor, I'm going to object to that kind of characterization.

THE COURT: You may have redirect. Proceed.

A So far as my efforts in respect to these contracts, it was almost an effort in futility.

[435] Q How was that?

A Well, so far as I know, no result ever came from it.

Q So in other words, we will assume that you brought the subject up and it was discussed, but yet your view was not accepted, is that correct?

A Well, there were other views beside mine because at the same time I was dispatched to Florida and other examiners were dispatched to larger companies engaged in this same type business, but I don't know the results of their finding, but at least with respect to this examination report, my advice was not taken.

Q By the Arizona department of insurance?

A That's right.

Q Would you say that you examined the question very carefully and exposed it very carefully to the department?

A Very carefully at the time I did, yes sir.

Q And the department did take it under consideration specifically.

A I recognized the contract because I had seen that type before and having an interest in it, I brought it to his attention. At a later time I became the assistant and acting director and I did not act on it because I was party at interest.

[436] Q I see, that's fine. Well, now let me ask you this, Mr. Robinson, at one time I did have an opportunity to look at the Arizona statute as it existed back at that time and do you recall that under that statute in order for reinsurance to be claimed as a credit, that the treaty

had to be submitted to the department prior to the—or with the annual report or had to be submitted physically?

A No sir, I don't recall that. That's been now so many years.

Q Would it have been common for the Arizona department to have had the reinsurance treaty there in its files?

A I couldn't say, sir.

THE COURT: Well, how did you get wind of the particular reinsurance practice there?

THE WITNESS: By an examination of the contract when I was on the examination of the Consumer Life Insurance Company.

BY MR. MASINTER: (Resuming)

Q Then I take it then that both in your examination of Consumer Life Insurance Company as of December 31, 1963, and American Bankers Life Insurance of 1963, both of the contracts, the reinsurance treaty which you have seen today were examined very carefully [437] in both of those examinations?

A That's correct.

Q And the result was that the State of Arizona did not require Consumer to establish the reserves on the accident and health insurance that we have under discussion today?

A I don't know what the general policy was, but they certainly did not require it in respect to this examination.

Q With that examination? Thank you, sir.

THE COURT: Redirect.

MR. MASINTER: Just one more question.

THE COURT: Oh, excuse me.

MR. MASINTER: No further questions, Your Honor.

THE COURT: Redirect?

MR. SCHWARZ: No further questions, Your Honor.

THE COURT: Thank you, sir, you may be excused.

MR. MASINTER: Your Honor, could we have about three minutes?

THE COURT: Are you assuming that this concludes the defense and you're going to deliberate about rebuttal, is that what you mean?

MR. MASINTER: Yes sir.

THE COURT: All right, does this conclude the [438] defense. That's all I wanted to be sure of.

MR. SCHWARZ: We had some tax returns that were offered and they have been—

MR. MASINTER: No objection.

THE COURT: They have been received.

MR. SCHWARZ: We have completed our case, Your Honor.

THE COURT: All right, then we'll take a five minute recess.

(Whereupon, a brief recess was held.)

MR. MASINTER: If Your Honor please, by way of rebuttal, we would like to call back to the stand Mr. Eddy because certain new terms were raised in the Defendant's case that we would like to have the opportunity to have expert testimony on it.

THE COURT: All right, Mr. Eddy, resume the stand and consider yourself remaining under the oath administered at the outset of your previous testimony.

A. CROOKS EDDY, having previously been sworn, resumed the stand, and testified further as follows:

DIRECT EXAMINATION

BY MR. MASINTER:

Q Mr. Eddy, are you familiar with the term of a surplus aid or surplus relief insurance and guaranteed profit insurance and if so, would you please explain [439] to the Court your opinion what such insurance constitutes and what those terms mean?

A Yes sir, I am and I'd like to use this chart to help illustrate my understanding of these types of contracts, if I may.

MR. LANDON: All right, this is Plaintiff's Exhibit 27. That's what I was ascertaining.

A The best way I believe to grasp the understanding and certainly the one that I have as an actuary of guaranteed profit contracts, would be to compare that with

the other types of contracts and specifically perhaps with the contracts involved in this particular case. Now, commence with the diagram on the left hand side of the chart on the screen which gives in essence the financial arrangements of a guaranteed profit and a surplus aid contract.

Q Say that again please?

A Well, these terms are pretty much synonomous, guaranteed profit and surplus aid as they are used in the sense that I have heard them used today.

Q So in other words, in this column entitled guaranteed profit agreement, it would also include the definition of surplus aid.

A So-called surplus aid contracts. Of course, [440] I think it ought to be understood that all of the contracts —all reinsurance contracts have an effect on surplus of one company or the other. Then as a matter of fact, on both companies and generally they're offsetting in nature. But specifically what has been referred to as surplus aid, I think today has to do with the type of contract that evolved a number of years ago and mostly after World War II, when many small fire and casualty companies came into existence with low capitalization and they were required to establish reserves on a gross unearned basis also, unearned premium basis, similar to the accident and health problem in this case.

What many of these companies found that they might do is to write large volumes of such insurance or large amounts of premiums of relatively low capital and in order to maintain the ratio that has been demonstrated in earlier charts, that is the ratio of premiums written to surplus—in order to maintain low ratios they would make arrangements with reinsurance companies, particularly near year end when the financial reporting was required, whereby they would reinsure any percentage of their risk up to 100 percent under an arrangement like column one. They would receive on such an arrangement a tentative commission of some [441] percentage of the amount of the premium being reinsured. This illustration, 45 cents is used because you'll find that—this particular type, three percent service charge which is also involved

or three percent profit to the reinsurer is also in this illustration.

Now, that commission, however, was tentative. The balance of the premium, namely 55 cents were remitted to the reinsurer who established on its books $1.00 reserve requirement. Now, as the claims were experienced, the reinsurer would pay claims up to an amount of 52 cents, retaining three cents out of the 55 cents for its own account. It would in effect, recover the 45 cent tentative commission and by way of having any claims in excess of 52 cents paid by the ceding company.

Now, in the earliest of these guaranteed profit contracts, the reinsurer was always guaranteed at least these three cents or three percent because any claims over 52 cents were, in the earliest of these contracts, absorbed by the ceding company. Now, modification of that type contract came along and it's been often used, whereby the limitation on the ceding company was 45 cents and in other words, its limitation or its responsibility for claims in excess of 52 cents would be limited to the amount of tentative commission that it had received.

[442] Now, another type of contract that has a feature of non-guaranteed portion of a commission is the center column which is referred to often as a contingent commission agreement. Now, this differs from the guaranteed profit agreement because the 45 cents commission is a guaranteed commission. It's paid at the outset just as with the guaranteed profit contract.

Then claims are paid out of the balance of the funds by the reinsurer, paid out of the 45 cents with an expectation that claims will not exceed 52 cents—excuse me, will not exceed—yes, 52 cents and based on the experience of various types of insurance that is reinsured, that are reinsured on this type of contract, these percentages are generally set, so as to be on the average, certainly adequate that the reinsurer will earn its three percent charge.

But under this type of contract they go ahead and commit themselves to a 45 cent guarantee commission. If claims do develop to be less than 52 cents, the reinsurer will make a—pay a contingent commission or if

you will examine the right hand column which is similar to the 1962 agreement, sometimes that contingent commission is referred to as an experience refund. At any rate, in both cases the amount that might be paid over and above the guarantee commission is contingent [443] upon the claims experience and normally the reinsurer is expecting to get its three percent.

Under contract one, or the guaranteed profit contract, in the earliest days it was assured it was going to get three percent, the reinsurer was going to get three percent. Later modifications said that—assured the reinsurer its three percent only if claims exceeded 97 cents—I mean if it were less than 97 cents.

Now, the contingent commission agreement is not that type. The reinsurer stands to lose its three cents if claims exceed 55 cents or if actually it commences to lose its three percent as soon as claims exceed 52 cents because it cannot make a claim against the ceding company for the guaranteed commission.

Now, the contingent commission may have a carry forward as in the '62 agreement if there had been a negative experience refund credit generated in any period. It was carried forward against possible positive experience refunds credits in subsequent periods, thereby giving more possibility that the reinsurer would get its ultimate three cents, but under both, the contingent agreement, the commission agreement or as its parallel the '62 agreement in this case, the fact is that the reinsurer was not guaranteed three percent and the [444] ceding company was in fact guaranteed its commission.

Now, the prohibition against taking credit for reserve by the ceding company for amounts held by the reinsurer under the guaranteed profit agreement are obvious. First of all, if it takes credit as having earned the 45 cents, which it does in effect by having the reinsurer establish a dollar reserve, where in fact, it may be called upon to pay back some of the 45 cents or mechanically to pay claims in excess of 52 cents, then without even if experience would justify them taking the 45 cents into their surplus as earned, they have—it is the NIAC's position

that this is forbidden until such amounts have actually been earned.

Under the commission agreement, the 45 percent—45 cents is permitted by the insurance regulatory officials as a credit because its guaranteed and it can only be—only the contingent commission is forbidden as a credit and that of course, only until after it's earned.

MR. SCHWARZ: Your Honor, we object to this answer if he's stating the policy of insurance departments with regard to contracts like that or if he's stating an answer with regard to NIAC policy.

THE WITNESS: I will change that to say that's the way that actuaries calculate it.

MR. SCHWARZ: I don't think their calculations [445] are relevant.

THE WITNESS: We have to calculate them for purposes of making our statements out which are approved or disapproved by the insurance departments.

THE COURT: He can testify as to his understanding of what this NAIC group's view is. I do think though that it ought to be made clear, if I correctly understand it, but when you're talking about this center column guaranteed commission and that this 45 cents cannot be encroached for purposes of responding to the reinsurer for claimed liability purposes, you're only talking about this within the context of some limited period and you're acknowledging, I take it, that on some sort of a carry forward basis that for a given period that 45 cents ceding carrier figure may well be encroached but it's only going to be encroached in the future as further experience permits the reinsurer's loss experience to go below what, 52 cents, I guess, is that right?

THE WITNESS: No sir, Your Honor, I'm saying that that 45 cents would never be encroached upon because under the terms of the contract until the expiration of the contract, or not ever for that matter. The only encroachment would be upon the contingent commission and also similarly under the '62 agreement the only encroachment is upon the experienced refund because as I [446] interpret the agreement, the claims are paid by the reinsurer, namely the American Bankers

to the extent of their portion of the liability and this becomes a negative factor in experience refund formula which is carried foward of subsequent periods but it's only applied against subsequent positive experience refunds amounts.

And I would like to, if I may, point out that if you would consider a zero profit to the reinsurer as being a guaranteed profit, then perhaps the 1957 treaty or treaty number one, could be characterized as a guaranteed profit because under that treaty, the Consumers profit could and would have been fixed at zero depending on the loss ratio, but it in my opinion more closely is identified with the 1962 agreement where the guaranteed commission is zero and all of its commissions or earnings are in fact experience repeat in nature.

MR. MASINTER: Could I ask you to refund that again, Mr. Eddy, about your opinion as to whether treaty one or treaty two in this case is or is not a surplus aid or guaranteed profit type of reinsurance?

THE WITNESS: It's my opinion that the '62 agreement demonstrated there and I believe that that properly reflects the agreement and that it is not a guaranteed profit or surplus aid contract as has been referenced here and if either of the treaties are, then [447] the treaty number one comes most close to that by having a zero guarantee to Consumer Life, the reinsuring company. But I really don't believe that zero is a proper—zero guaranteed profit is a proper way to classify a guaranteed profit contract, so I really feel that both treaties actually fall under the '62 agreement format that's shown here on this chart.

THE COURT: You approach the definition of surplus aid from the standpoint of premium split rather than from the standpoint of risk allocation or risk shifting, is that right? I hadn't heard you say anything about that and I thought that the prior witnesses—that that really was the touchstone of surplus aid was the situation where premium monies shifted out of synch as it were, with risk shifting and their definition of pure surplus aid would be where no risk at all was in fact

assumed by the party who was purporting to carry reserves. He had reserves without risks.

THE WITNESS: I think I agree with that, Commissioner, if you take the column 1, the guaranteed profit—agreement, what in its earliest form, the ceding company reinsured 100 percent of the risks presumably for which it transmitted 55 cents to the reinsurer, but in fact since the reinsurer could call on the ceding [448] company to pay claims in excess of 52 cents and in the earliest of these contracts to pay all claims in excess of 52 cents, later versions of that guarantee or modifications of it, the ceding company was limited to the 45 cents that it had retained, but there would be the case that in the earliest form of this guaranteed profit agreement, the surplus aid contract was supposed to be 100 percent of the shift of the risk to the reinsured but in fact if claims exceeded this 52 cents, some of the burden was still on the ceding company and it was only the 45 cents that was forbidden as a reserve credit on the ceding company. It still could claim the 52 cents as a reserve credit because the premiums were being held by reinsurer and we had to presume an acceptable reinsurer, qualified reinsurer but it was only denied the 45 cent credit and not the 52 cents credit.

THE COURT: Do all three columns of Plaintiff's 27 for identification presuppose that the ceding carrier carries all risk?

THE WITNESS: No sir, in all three columns differ in that respect. The guaranteed profit column assumes that it does effectively carry the risk because of the charge back nature, but columns 2 and 3 do not assume that. It assumes that the reinsurer carries the risk and the only corridor or margin between what [449] is set aside for payment of claims and what might be a conditional or additional payment to the ceding company is either a contingent commission or the experience refund column and it's only that corridor used as a carry forward that helps stabilize the position of the reinsurer but under both columns 2 and 3 of that chart it is presumed that the reinsurer assumes the risk with that carry forward provision only, is an exception.

THE COURT: And yet columns 2 and 3 exemplify to you embodiments of your understanding of a surplus aid agreement?

THE WITNESS: No sir, I put those there to compare them with the surplus aid agreement. The left column only is the one that I consider the surplus aid agreement.

BY MR. MASINTER: (Resuming)

Q So in other words, you don't feel in your thinking that the '62 agreement or the '57 agreement is surplus aid agreement as you understand it?

A No sir, if either of them could either be closely identified with it, it would have to be the '57 agreement or treaty number one because it had the contingency was on the Bankers—American Bankers, they were the ones that had to pay the claims of the premiums. I mean, the only thing remitted to Consumers [450] from American Bankers is what's left over. Now, there was some liability to American—I mean, to Consumer the reinsurer after the program had been in operation for a period of time because if it had received some monies from American Bankers, my understanding of that treaty, is that American Bankers could come back to them to recover what they had received and also confiscate anything that they might otherwise receive in the future until such excess claims had been paid by American Bankers had been recovered.

Q Let me ask you this, Mr. Eddy, you heard testimony of the two witnesses or one witness for the Defendant who expressed his views that these were surplus aid insurance contracts or reinsurance contracts. Would you explain how your opinion differs from their opinion and can you pinpoint the areas of where they might differ?

A Of course, I don't know why the other witnesses feel that they, as they state they feel. I say that these are not surplus aid in the sense or guaranteed profit contracts because certainly the reinsurer had the risk of a loss although based on the loss ratios that they are familiar with with the particular business that they had

been selling, that they didn't expect any loss, in my opinion there could have been a loss [451] to the reinsuring company.

Q There could have been a loss?

A Yes.

Q But you think that the prior witnesses assumed that there could not have been?

A Right, and I say again the only treaty that's close to not having any risk as a reinsurer was the first treaty, but there was a loss element in it once the program had been underway profitably for any period of time because of the recovery aspect.

MR. MASINTER: We have no further questions.

THE COURT: Mr. Schwarz.

MR. SCHWARZ: Your Honor, could you give us a minute or two please?

THE COURT: Yes, you can have a minute but are you going to have further need for this picture?

MR. SCHWARZ: Yes, I think we will, Your Honor.

THE COURT: Proceed.

CROSS EXAMINATION

BY MR. GROSSMAN:

Q Now, sir, you explained that there was a guaranteed of three percent commission under the first guaranteed profit agreement, is that correct, in column 1?

A Yes.

[452] Q And that the entire risk of loss was with the ceding company under that contract?

A In its original version yes. Assuming that the claims if they exceeded 97 cents would be paid out of other funds of the ceding company.

Q Now, when the Commissioner asked you whether or not the risk under the other two types of policies shown there was transferred to the reinsurer you didn't mean that the entire risk was transferred to the reinsurer, did you?

A Well, to the extent of the agreement, now, if it was sharing 80 percent, 80/20 as it was in the '62 agreement—in the beginning of the '62 agreement, this

chart refers to each dollar of reinsurance that was ceded. Actually only 80 percent of the original dollar was ceded.

Q Yes, but under both types that you show there, isn't the risk on reinsurer only limited to its three percent commission?

A Not at all, if claims exceed in the center column, if claims exceed 55 cents and the reinsurer must make up those deficits out of some other funds of its own.

Q Yes, but that is the temporary limit that we're talking about, again now, isn't it?

[453] A Well, no, that's permanent unless there would be in the future out of 55 cents collected from future premiums, there would be some margin with which it could recover what it had taken out of its other funds and from prior poor experience, then it is a permanent arrangement.

THE COURT: But you are telling us it would never have a call for that excess on the ceding company?

THE WITNESS: Right.

BY MR. GROSSMAN: (Resuming)

Q And that is your interpretation of both the contracts, the 1957 and 1962 contracts?

A That is my interpretation of the '62 contract. The '57 contract is essentially the same. There is no call on the—excuse me, the '57 contract, the American Bankers would be ultimately liable for all of the claims, so it—the '57 contract comes closer to being guaranteed profit agreement than the '62.

Under the '62 contract, the American Bankers would have to pay the claims whatever they were. Now, it might hope to recover through this experience refund from profitable future business but it would not have a call on the 50 cent commissioner that it had—50 percent commission it had already paid out, under the '62 agreement.

[454] Q And when you refer to the '57 agreement you're referring to it as amended in 1958, is that correct?

A That is correct.

Q And it wouldn't be so prior to the amendment even under your interpretation of the contract.

A Well, I'll have to think about that because I didn't have in my mind, the contract without the amendment. I'd have to study it and just quickly I can't tell you, but I consider that the amendment was effective from the beginning so I think that's—effective from the outset of the contract, as I see it and understand it.

Q Well, you do recognize that there had been a cushion built up by the time the contract had been modified?

A Well, it—

Q That is taking into account specifically because of the retroactive nature of the amendment.

A Well, I would say this, I have heard testimony in this Courtroom where it was I believe said that there may have been some cushion, that it had been profitable business. I don't believe that anyone ever testified as to how much cushion was there, but reading the treaty, it's obvious that that's a typographical error. In my opinion, it was meaningless the way it was worded [455] in the outset, but whether that was the real reason for their modification or for some other reason, I don't know.

Q That's just speculation on your part?

A That's correct.

CROSS EXAMINATION (Continued)

BY MR. SCHWARZ:

Q Just one or two other questions, Mr. Eddy. Did you hear Mr. Born's testimony to the effect that the possibility of that negative balance, that is the negative balance of claims in any one month over the earned premium under the 1962 treaty, not being eventually offset by earned premiums for any other months, was extremely remote?

A I believe I heard those words, yes.

Q And assuming that to be correct then—

A Those were his opinion. You are asking did I hear him to say that to be his opinion?

Q Yes.

A Yes sir, I heard that.

Q Under the assumption that his opinion's correct, that three percent is a guaranteed profit for the reinsurer, is it not?

A To the extent that your assumptions as to morbidity are correct, there's a guaranteed profit for [456] everybody there.

Q So isn't it academic then to ask whether the 50 percent that's retained by the ceding company is subject to invasion at any time or not? That assumption again.

A Under that assumption, of course, yes.

MR. SCHWARZ: We have no other questions.

MR. MASINTER: I think he ought to have the right to explain his answer.

MR. SCHWARZ: Go ahead, Mr. Eddy.

THE WITNESS: Well, I say under the assumption the only thing that's certain is uncertainty and we've had examples where claims loss ratios has exceeded the figure for their own—and in which case—in credit insurance and particularly A and H so it may have been remote on averages but I think it's—I wouldn't want to say that it was impossible for there to have been a loss to American Bankers. I think that was one of the contingencies involved.

MR. SCHWARZ: No further questions.

THE COURT: Mr. Masinter.

MR. MASINTER: Yes sir, I have one question.

REDIRECT EXAMINATION

BY MR. MASINTER:

Q You stated a few minutes ago, that under the [457] 1957 treaty, agreement one that the ultimate liability was on American Bankers. Would you explain what you mean by ultimate liability?

A Well, under treaty one as I understand it, the only money that was ever passed on to Consumer, the reinsurer, were monies that had been earned because of the passage of time where claims were less than the amount of premiums paid.

Q This is only on A and H?

A Yes, I'm speaking only of A and H and less, of course, American Bankers retention of their 12 and ½ cents in the outset. Now, the—at the very outset of that agreement, there was no claim against Consumer for anything because there was no accumulation of any sort of experience. As time wore on, and as they stated, it was profitable and there was a fund they had accumulated earnings, through this monthly operation of this agreement, once the treaty—once adverse claims were encountered so that there was a deficit for some accounting period as I understand the '57 agreement, the Consumer then could be called on to pay back what it had earned in the prior months and not only that they would then have to forfeit any earnings of the business in future months until the American Bankers had recovered the excess claims over premiums minus the 12 and ½ cents.

[458] Q So I was just confused by you using the term ultimate liability. You didn't mean then to say that under the treaty that this did not carry forward in the manner that you just described, but in fact it did carry forward?

A Oh yes, it did to that extent and the carry forward, of course, was against any earnings, future or past that may have been received by Consumer.

Q I just wanted to clarify that so we would have no misunderstanding with respect to the record.

MR. MASINTER: Thank you, Your Honor, I have no further questions.

THE COURT: Anything further from the Government?

MR. SCHWARZ: I have just one other question on the '57 agreement.

RECROSS EXAMINATION

BY MR. SCHWARZ:

Q The surplus of the reinsurer, Consumer, was aided under that agreement, wasn't it, where it retained the ultimate liability but did not have to show the unearned premium reserve. It earned all the profits from the contract except the commission.

A No, I think that you got it backwards. I think the surplus aid would have been, if this could have been in that category, would have been directed at [459] American Bankers but it didn't attempt to take any credit for the reserves so it didn't actually take advantage of the surplus aid aspects that this type of an agreement would have offered.

Q Had Consumer set up an unearned premium reserve for this having not received the premiums and did not offset it with an asset its surplus would have been invaded, would it not?

A Right, this then would have become pretty much a surplus aid contract, but it would have been American Bankers surplus you would have been aiding.

MR. SCHWARZ: I have no further questions.

THE COURT: Mr. Masinter? All right, well just a couple things here. First of all, do you recall telling me yesterday in response to my question that—as to whether the probabilities of loss experience on A and H coverage were amenable to actuarial projection and you answered that in the affirmative.

THE WITNESS: I did, yes sir.

THE COURT: All right, did you hear the—some reference to that in prior testimony today from other witnesses to the effect that taking A and H coverage as an across the board quantity that the particulars of such coverage differed sufficiently, carrier to carrier and policy to policy, that it would [460] not be susceptible of a defined hazard norm as in the case of life, now did you mean in giving me the affirmative answer, that this was conceptually possible, but do you at the same time recognize that if from the standpoint say of a regulatory body, it were to undertake to prescribe as it, I suppose, does in the life situation a morbidity table for A and H policies that this would not be feasible because of the differences in distinctions, policy to policy.

THE WITNESS: I heard the contradictory testimony and I still will say that I was correct in what I told you yesterday.

THE COURT: I'm not implying that you weren't correct. I'm asking you though whether you were saying that in principle, yes, this can be done, but at the same time do I understand that you would go along with the idea that as a matter of practicality there would be no such thing as a morbidity table for A and H because of these little coverage or exposure differences, policy to policy.

THE WITNESS: No, I don't go along with that and I can give you some specifics if you like.

THE COURT: All right, you don't go along with it?

THE WITNESS: No sir, there have been studies [461] quite extensive, recent statistical information on this, including credit accident and health.

THE COURT: All right, now there's been a good deal of—you didn't make any morbidity calculations for the coverages involved in this proceeding, did you?

THE WITNESS: I did make an analysis of this company's business using the State of California's morbidity table with respect to credit insurance some year or so ago, yes sir.

THE COURT: And you've put that in the record?

THE WITNESS: No, we didn't use that information.

THE COURT: Now, there's been considerable reference to this Penn Security case in which I believe you indicated you had testified as an expert. In an opinion of March 2, 1973 in that matter by Commissioner Fletcher, there are findings 19 and 20. Finding 19 concludes with the following sentence which I assume refers to you, correct me if I'm wrong. The sentence is "ceding companies, however, may obtain a credit on their annual statement forms for unearned premium reserves, actually transferred to a reinsurer, since as explained by the Plaintiff's expert, the liability for an unearned premium reserve 'depends on whether you got the money or not'". Do I correctly understand that taking that in the light of your testimony yesterday [462] you are saying that the reserve you believe depends on who has the money in the first instance so to

speak, that at the same time you recognized that whether you want to call it carry forward or extension or the big picture or the broad view, that this initial allocation of money can be the subject of ultimate revision and readjustment which revision and readjustment will result in the last analysis with an alignment between premium apportionment and risk bearing apportionment. Is that correct?

THE WITNESS: Yes sir, I believe that's what I believe, yes.

THE COURT: That would sort of be the balance of what he's quoting you about.

THE WITNESS: Commissioner, may I add one thing there?

THE COURT: Yes.

THE WITNESS: Another concept or another factor is that the very name of the reserves held for accident insurance. In my opinion supports the notion that the premium—I mean the reserve follows the premium because the name of the liability is an unearned premium reserve.

THE COURT: I understand. The finding 20 next succeeding concluded with the statement, "Plaintiff [463] was not required to establish an unearned premium reserve with respect to its reinsurance of the ceding companies because as of each statement date, no portion of the reinsurance premiums received and held by Plaintiff represented payment for insurance to be provided after the statement, i.e. all such reinsurance premiums were fully earned" and again this is within the context of a focus on the immediate time frame reference, correct?

THE WITNESS: Yes sir.

THE COURT: And does not mean that that's not subject to change in the overall—anything further from either side in that connection.

MR. GROSSMAN: Yes. Your Honor, I have a few more questions based on an answer that was just given to you.

THE COURT: You're serious that you have something further?

MR. GROSSMAN: I think that something that was said was somewhat contradictory to something else that was said.

MR. SCHWARZ: Your Honor, could we just have one minute?

THE COURT: Yes.

(Discussion off the record.)

THE COURT: I did not understand there to [464] be any contradictions. If there were, they alluded me.

Very well, the trial then is concluded and I want to say that I think that both sides are well represented and I appreciate the courtesy that both sides have extended to each other in the trial of the cause. I'll tell the reporter that I, in accordance with Rule 122D am prescribing that in lieu of filing of this transcript within 30 days with the Clerk, I will expect that within that 30 day period, the reporter will retain the exhibits, retain custody of the exhibits, will within the 30 day period instead of filing a transcript with the Clerk, supply each side with a copy of the proposed transcript, at which time counsel will have 14 days, following within which to consult—review the transcript. It's not that big, compile any proposed corrections that they perceive, consult informally with the other side and attempt to achieve an agreed list of any changes that you want made, forward that to the reporter, following which it would—receipt of which it would seem to me the reporter in ten additional days can file the transcript with the Clerk, which in those circumstances should be the transcript subject to no further corrections or motion, practice or anything of that sort and the exhibits are to be filed at that time.

Upon such filing I will issue the notice of [465] closing and the parties will proceed under the rule 134. Any questions.

MR. MASINTER: Does that mean the briefs will be due from the date of filing?

THE COURT: I will issue the notice of closing upon the filing but my experience has been that if a transcript is filed before counsel has had a chance to look at it, it simply makes for a lot of unnecessary paperwork and ultimate withdrawal for correction and such that can be avoided under this procedure.

MR. MASINTER: I agree with that and I think you're quite right.

THE COURT: All right, we'll do that that way. The Court understands that this is Mr. Schwarz' swan song, so we wish you good luck in your future endeavors, Mr. Schwarz.

MR. SCHWARZ: Thank you, Your Honor.

THE COURT: All right, we stand adjourned.

(Whereupon, the trial was adjourned as described above.)

[PLAINTIFF'S EXHIBIT 2]

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

Landon Building
343 N. E. Second Avenue
Miami 32, Florida

"Life Protection for Every Need"

REINSURANCE AGREEMENT

between the

AMERICAN BANKERS LIFE
ASSURANCE COMPANY

of Miami, Florida, hereinafter referred to as "American Bankers", party of the first part, and CONSUMER LIFE INSURANCE COMPANY Arizona

ARTICLE I

American Bankers agrees to cede to Consumer Life and Consumer Life agrees to accept reinsurance to the extent set forth below:

One Hundred Per Cent (100%) of each and every Life policy and each and every Health and Accident policy (herein called "Life policies" and "Health and Accident policies") issued by American Bankers in respect to debtors of Consumer Life and its subsidiary and affiliated corporations. The liability of Consumer Life under said Life and Health and Accident policies shall follow the liability of American Bankers except that the liability of Consumer Life arising under its reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable by Consumer Life under the provisions of Article V prior to the termination of this agreement.

ARTICLE II

This agreement applies to all said policies issued by American Bankers on or after the 1st day of July, 1957.

ARTICLE III

American Bankers shall furnish Consumer Life on or before the 20th day of July, 1957, and on or before the 20th day of each month thereafter, a statement showing the following information on transactions of the preceding month:

A. On all Life policies the statement will show:

(1) The amount of premiums collected;

(2) The amount of premiums returned on account of cancellation or other reasons; and

(3) The amount of losses paid.

B. On all Health and Accident policies the statement will show:

(1) The amount of premiums collected;

(2) The amount of premiums returned on account of cancellation or other reason;

(3) The amount of losses paid;

(4) The amount of losses reported and unpaid and the estimated amount of losses incurred and unreported at the end of the preceding month; and

(5) The amount of premiums earned.

For the purpose of computing premiums earned during any month on Health and Accident policies under this Article III, the sum of the premiums collected on policies written during the month less any premium returned because of cancellation or other reason during the month, shall be added to the unearned premium reserve at the beginning of the month on policies then in force, and from the total sum so obtained shall be subtracted the

unearned premium reserve at the end of the month on policies in force at that time.

For the purpose of computing losses, losses reported and unpaid and losses incurred and unreported, the allocated loss expense shall be added to the amount of loss claims. In this connection the allocated loss expense shall be all claim expenses over and above the usual claim expenses incurred in the routine handling of a claim in the ordinary course of business, it being the intent of the parties hereto to include such expenses as the hiring of a special investigator, unusual travel expense in connection with the handling of a claim, attorney's fees arising from a claim and other expenses not incurred in the usual and ordinary course of handling a claim.

ARTICLE IV

In addition to the monthly statement set forth in Article III, American Bankers agrees to furnish Consumer Life on or before the 20th day of January each year and from time to time as may be requested by Consumer Life, but in no event more often than monthly, a statement containing the following information as at the end of the month preceding the statement:

A. The amount of reserve on all Life policies then in force;

B. The amount of losses on Life policies reported and unpaid and the estimated amount of losses incurred but unreported;

C. The amounts of insurance on all Life policies;

D. Such other information as may be required to complete annual statements or other statements as required by law.

Consumer Life shall, at all reasonable times during this agreement, have full and free access to all books, records and files of American Bankers' office with respect to the business covered by this agreement.

ARTICLE V

In consideration of the reinsurance as set forth in Article I, the American Bankers agrees to pay monthly

to Consumer Life, based on the statement set forth in Article III for the preceding month, and payable at the same time: (1) Eighty-seven and One-half Per Cent (87½%) of the premiums collected less any premiums returned on all Life policies, and (2) Eighty-seven and One-half Per Cent (87½%) of the premiums earned on all Health and Accident policies.

Consumer Life agrees to reimburse American Bankers before the 30th day of the month after such statement is submitted, for all losses actually paid during the preceding month on Life policies and all losses actually paid during the preceding month on Health and Accident policies plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

ARTICLE VI

American Bankers shall maintain all unearned premiums, loss and other reserves as may be required by law against all Health and Accident policies. Consumer Life shall maintain policy and other reserves as may be required by law on all Life policies.

ARTICLE VII

American Bankers agrees to pay all state, county, or city taxes which may be or become due in connection with the insurance sold or premiums collected on policies reinsured under this agreement.

ARTICLE VIII

American Bankers has furnished to Consumer Life and Consumer Life has acknowledged having received from American Bankers specimen forms upon which all said policies covered hereby are currently written. American Bankers reserves the right to make changes in such forms from time to time, but shall promptly notify Consumer Life of all such changes.

ARTICLE IX

The supervision and payment of all claims on policies covered by this agreement shall be handled by American

Bankers and the decision of American Bankers in settling, rejecting or defending such claims shall be binding on Consumer Life.

ARTICLE X

In the event of the insolvency of the American Bankers, all reinsurance shall be payable directly to the liquidator, receiver or statutory successor of said American Bankers, without diminution because of the insolvency of American Bankers.

In the event of insolvency of American Bankers, the liquidator, receiver or statutory successor shall give Consumer Life written notice of the pendency of a claim on the policy reinsured within a reasonable time after such claims are filed in the insolvency proceeding. During the pendency of any such claim, Consumer Life may investigate such claim and interpose in the name of American Bankers (its liquidator, receiver or statutory successor,) but at its own expense, in the preceding where such claims are to be adjudicated, any defense or defenses which Consumer Life may deem available to American Bankers or its liquidator, receiver or statutory successor.

ARTICLE XI

All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the agreement obligation.

The court of arbitrators which is to be held in the city of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this agreement. One of the arbitrators is to be appointed by American Bankers, the second by Consumer Life and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbi-

trator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the president of the American Life Convention.

The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall be borne by the loosing party unless the arbitrators shall decide otherwise.

ARTICLE XII

This agreement constitutes the entire contract between the parties and may not be altered, modified or in any ways amended except by an instrument in writing duly executed by the proper official of both parties.

ARTICLE XIII

This agreement may be terminated by either party effective on the last day of any month upon at least thirty (30) days written notice of the other party.

Upon termination by either party, this agreement shall continue to apply to all policies reinsured hereunder before such termination becomes effective.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be signed and sealed by their duly authorized officers on this 28 day of June, 1957.

THE AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

/s/ [Illegible]

By /s/ [Illegible]

CONSUMER LIFE INSURANCE COMPANY

/s/ [Illegible]

By /s/ [Illegible]

ADDENDUM TO REINSURANCE AGREEMENT

This Agreement, made this 26th day of November, 1957, and effective the 1st day of November, 1957, by and between CONSUMER LIFE INSURANCE COMPANY OF ARIZONA, hereinafter designated as "CONSUMER LIFE", and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami and State of Florida, hereinafter designated as "AMERICAN BANKERS".

WITNESSETH:

WHEREAS, AMERICAN BANKERS and CONSUMER LIFE entered into a Reinsurance Agreement on the 1st day of July, 1957, and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. The first paragraph of Article V of said Agreement is hereby amended as follows:

> "In consideration of the Reinsurance as set forth in Article I, AMERICAN BANKERS agrees to pay monthly to CONSUMER LIFE based on the statements set forth in Article III for the preceding month and payable at the same time: (1) A percentage of the premiums collected less any premiums returned on all Life policies and (2) A percentage of the premiums earned on all Accident and Health policies.
>
> "The percentages above shall be on a sliding scale based upon written premiums for each fiscal year beginning November 1, 1957 and each year thereafter as shown on the table below:

ANNUAL VOLUME	% of PREMIUMS
$ -0- —$200,000	87½%
200,000— 500,000	89½%
500,000 And Over	91% "

3. All other terms and conditions not amended hereby shall remain in full force and effect.

Witness:

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

/s/ [Illegible]

By /s/ [Illegible]

CONSUMER LIFE INSURANCE COMPANY

/s/ [Illegible]

By /s/ [Illegible]

ADDENDUM TO REINSURANCE AGREEMENT

This Agreement, made this 28th day of May, 1958, and effective the 1st day of April, 1958, by and between CONSUMER LIFE INSURANCE COMPANY OF ARIZONA, hereinafter designated as "CONSUMER LIFE", and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami and State of Florida, hereinafter designated as "AMERICAN BANKERS".

WITNESSETH:

WHEREAS, AMERICAN BANKERS and CONSUMER LIFE entered into a Reinsurance Agreement on the 1st day of July, 1957, and amended said agreement the first day of November, 1957, and

WHEREAS, the parties are mutually desirous of amending said Agreement and Addendum as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. The first paragraph of Article V of said Agreement is hereby amended as follows:

   "In consideration of the Reinsurance as set forth in Article I, AMERICAN BANKERS agrees to pay monthly to CONSUMER LIFE based on the statements set forth in Article III for the preceding month and payable at the same time: (1) A percentage of the premiums collected less any premiums returned on all Life policies and (2) A percentage of the premiums earned on all Accident and Health policies.

   "The percentages above shall be on a sliding scale based upon WRITTEN PREMIUMS for each fiscal

year beginning April 1, 1958, and each year thereafter as shown on the table below:

ANNUAL VOLUME	% of PREMIUMS
$ -0- —$200,000	87½%
200,000—and over	90½%

3. All other terms and conditions not amended hereby shall remain in full force and effect.

Witness:

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

/s/ Marcia Flanigan

By /s/ [Illegible]

CONSUMER LIFE INSURANCE COMPANY

/s/ J. F. Miller, Jr.

By /s/ [Illegible]

ADDENDUM TO REINSURANCE AGREEMENT

This Agreement, made this 28th day of May, 1958, and effective the 1st day of July, 1957, by and between CONSUMER LIFE INSURANCE COMPANY OF ARIZONA, hereinafter designated as "CONSUMER LIFE", and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami and State of Florida, hereinafter designated as "AMERICAN BANKERS".

WITNESSETH:

WHEREAS, AMERICAN BANKERS AND CONSUMER LIFE entered into a Reinsurance Agreement on the 1st day of July, 1957 and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I of said Agreement is hereby amended as follows:

   "American Bankers agrees to cede to *Consumer Life* and *Consumer Life* agrees to accept reinsurance to the extent set forth below:

   One Hundred Percent (100%) of each and every Life Policy and each and every Health and Accident policy (herein called "Life Policies" and "Health and Accident Policies") issued by American Bankers in respect to debtors of *Southern Discount Company (Georgia)* and its subsidiary and affiliated corporations. The liability of *Consumer Life* under said Life and Health and Accident

   Policies shall follow the liability of American Bankers except that the liability of *Consumer Life* arising under its reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable to *Consumer Life* under the provisions of Article V prior to the termination of this agreement."

3. All other terms and conditions not amended hereby shall remain in full force and effect.

Witness:

/s/ Marcia Flanigan

/s/ J. F. Miller, Jr.

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ [Illegible]

CONSUMER LIFE INSURANCE COMPANY

By /s/ [Illegible]

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 26th day of January, 1959, and effective the 1st day of January, 1959, by and between Consumer Life Insurance Company of Phoenix, Arizona hereinafter designated as Consumer, and American Bankers Life Assurance Company of Florida, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami and State of Florida, hereinafter designated as "American Bankers."

WITNESSETH:

WHEREAS, American Bankers and Consumer entered into a Reinsurance Agreement on the 28th day of June, 1957, and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY AGREED AND UNDERSTOOD AS FOLLOWS:

1. The Terms and Conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.
2. Article V in its entirety shall read as follows:

ARTICLE V

In consideration of the reinsurance as set forth in Article I, American Bankers agrees to pay monthly to Consumer based on the statement set forth in Article III for the preceding month, and payable at the time said statement is rendered:

See Addendum dated

(1) May 28, 1958 Per Cent (——%) of the premiums collected, less any premiums returned, on all Life insurance, and

See Addendum dated

(2) May 28, 1958 Per Cent (——%) of the premiums earned on all Health and Accident insurance.

A. Consumer agrees to reimburse American Bankers, before the 30th day of the calendar month in which such statement is submitted, for all losses actually paid by American Bankers during the preceding calendar month on Life insurance and all losses actually paid by American Bankers during the preceding month on Health and Accident insurance, plus any increase or less any decrease during said month in the amount of Health and Accident losses reported and unpaid and incurred and unreported.

B. It is further agreed that in addition to the amount stated in Article V A. hereof, Consumer shall, on or before January 31, of each year, reimburse American Bankers on risks reinsured on insureds whose debts are created under the Georgia Industrial Loan Act in the amount equal to the difference between:

(1) Twenty Per Cent (20%) of the premiums collected less any premiums returned on all Life Insurance and,

(2) Twenty Per Cent (20%) of the premiums earned on all Health and Accident Insurance.

and losses as defined in Article V, Paragraph A, above on insureds whose debts are created under the Georgia Industrial Loan Act.

Witnesseth:

_____

_____

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ [Illegible]

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

P.O. Box 4980
600 Brickell Avenue
Miami 29, Florida
Phone FRanklin 3-8664

June 9, 1959

Consumer Life Insurance Company
Phoenix,
Arizona

Attn: Mr. W. King Grant

Gentlemen:

This letter, effective January 1, 1959, shall serve to amend our Reinsurance Agreement dated June 28, 1957. On and after January 1, 1959, Article V of said Agreement is further amended to provide that on business emanating from subsidiaries of Southern Discount Company, premiums ceded shall be 20% less than the premiums shown in the addendum to the contract dated May 28, 1958.

The addendum dated January 26, 1959 shall remain in full force and effect.

Please sign and accept this addendum retaining one copy for your files.

Very truly yours,

/s/ R. Kirk Landon
R. Kirk Landon
Senior Vice President

RKL:sl

ACCEPTED:

/s/ W. King Grant
Consumer Life Insurance Company

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

P.O. Box 4980
600 Brickell Avenue
Miami 32, Florida
Telephone:
FRanklin 3-8664

November 10, 1959

Consumer Life Insurance Company,
Phoenix
Arizona

Attention: Mr. W. King Grant

Gentlemen:

This letter will serve to amend our Reinsurance Agreement dated June 28, 1957 and amending letter thereto dated June 9, 1959.

Effective December 1, 1959 Article V of said Agreement is amended to provide that with regard to business emanating from the subsidiaries of Southern Discount Company listed below, premiums ceded shall be 50 percent less than the premiums shown in the Addenum to the Agreement dated May 28, 1959. All other terms and conditions of the Agreement and Addenda shall remain in full force and effect.

The following subsidiaries of Southern Discount Company shall be effected hereby:

Local Finance Company of Tampa, Local Finance Company of Plant City, Local Finance Company of Bartow (Florida), Local Finance Company of Haines City, Local Finance Company of Starke (Florida), Local Finance and Discount Company, Tampa, Local Finance Company, Tampa, Florida, Consumer Loan Service of Decatur, Alabama, Inc., Consumer Discount Company, Decatur, Alabama.

Please indicate your acceptance of the foregoing by executing below in the place provided and retaining a copy for your files.

/s/ R. Kirk Landon
R. KIRK LANDON, President

Accepted this 13 day of March, 1959.

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant

ADDENDUM TO REINSURANCE AGREEMENT

This Agreement, made this 10th day of November 1959 and effective the 1st day of December, 1959, by and between CONSUMER LIFE INSURANCE COMPANY OF ARIZONA, hereinafter designated as "CONSUMER LIFE", and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami and State of Florida, hereinafter designated as "AMERICAN BANKERS".

WITNESSETH:

WHEREAS, AMERICAN BANKERS and CONSUMER LIFE entered into a Reinsurance Agreement on the first day of December 1959 and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated with the terms of this Agreement.

2. Article 1 of said Agreement is hereby amended as follows:

   "American Bankers agrees to cede to Consumer Life and Consumer Life agrees to accept reinsurance to the extent set forth below:

   One Hundred Percent (100%) of each and every Life Policy and each and every Health and Accident policy (herein called "Life Policies" and Health and Accident Policies") issued by American Bankers in respect to debtors of Local Finance Company of Tampa, Local Finance Company of Plant City, Local Finance Company of Bartow (Florida), Local Finance Company of Haines City (Florida), Local Fi-

nance Company of Starke (Florida), Local Finance Company, Tampa, Local Finance & Discount Company, Tampa (Florida), Consumer Loan Service of Decatur, Alabama, Inc., Consumer Discount Company, Decatur, Alabama. The liability of Consumer Life under said Life and Health and Accident Policies shall follow the liability of American Bankers except that the liability of Consumer Life arising under its reinsurance of said Health and Accident policies is on a month to month basis only and is limited solely to such amounts as shall become payable to Consumer Life under the provisions of Article V prior to the termination of this Agreement".

3. All other terms and conditions not amended hereby shall remain in full force and effect.

Witness:

/s/ Sandra Lehay

/s/ Margie Holt

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ R. Kirk Landon

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant

R. REID SANDERSON, *Assistant Secretary and Counsel*

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

P.O. Box 4980
600 Brickell Avenue
Miami 32, Florida
Telephone:
FRanklin 3-8664

June 9, 1961

Consumer Life Insurance Company,
Phoenix
Arizona

Attention: Mr. W. King Grant

Gentlemen:

This letter will serve to amend our Reinsurance Agreement dated June 28, 1957 and amending letter thereto dated June 9, 1958 and letter dated November 10, 1959.

The following subsidiaries of Southern Discount Company shall be included under the terms and conditions of the Reinsurance Agreement and Amendment thereto and shall be treated as set forth in our letter dated November 10, 1959.

Local Finance and Acceptance Co., 1511 S. Dale Mabry, Tampa, Florida;

Local Finance & Acceptance Co., 101 S. Evers St., Plant City, Florida;

Local Finance & Acceptance Co., 405 E. Main St., Bartow, Florida;

Local Finance & Acceptance Co., 30 N. 6th St., Haines City, Florida;

Local Finance & Acceptance Co., 114 N. Walnut St., Starke, Florida;

Local Finance & Acceptance Co., 205 Twiggs St., Tampa, Florida and

Local Finance & Acceptance Co., 408 Madison St., Tampa, Florida.

Please indicate your acceptance of the foregoing by executing below in the place provided and retaining a copy for your files.

/s/ R. Kirk Landon
R. KIRK LANDON, President

Accepted this 16th day of June, 1961.

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant

Mr. W. King Grant,
Consumer Life Insurane Company
919 West Peachtree Street, N.E.
Atlanta, Georgia

Dear King:

This letter will serve to amend our Reinsurance Agreement dated June 20, 1957, and amending letters thereto.

As of the 28th day of August, 1961, the subsidiaries of Southern Discount Company, located in the State of North Carolina, shall be included under the terms and conditions of the Reinsurance Agreement and Amendments thereto.

Effective the 28th day of August, 1961, Article V of said Reinsurance Agreement is amended as follows with regard to the business originating under the Southern Discount Subsidiary, State of North Carolina:

> In consideration of the Reinsurance, as set forth in ARTICLE I, the American Bankers agrees to pay monthly to Consumer Life, based on the statements set forth in ARTICLE III for the preceding month, and payable at the same time: (1) Eightyseven and one-half per cent (87½%) of the premiums collected, less any premiums returned on all Life policies, and (2) Eighty-seven and one-half per cent (87½%) of the premiums earned on Health and Accident policies, and there shall be deducted (i) the cumulative total losses and the loss expenses paid, or 40% of the net premiums earned, whichever is greater, and (ii) all of the company's reserves and all claims outstanding, including incurred but unreported claims, and (iii) all commissions paid by the Company to the Agent cumulative, and (iiii) the cumulative total of all amounts previously paid to the Agent.

Should the remainder be a minus figure, the minus figure should be paid by Consumer Life Insurance Company to American Bankers Life Assurance Company before the

30th day of the month after such statements are submitted.

All other terms and conditions of said Reinsurance Agreement and Addenda shall remain in full force and effect.

Please indicate your acceptane of the foregoing by executing below in the space provided, retaining a copy for your files.

/s/ George D. Floyd
GEORGE D. FLOYD,
Vice President

Accepted this 28th day of Aug., 1961.

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

P.O. Box 4980
600 Brickell Avenue
Miami 32, Florida
Telephone:
FRanklin 3-8664

January 4, 1962

Consumer Life Insurance Company
Phoenix
Arizona

ATTENTION: Mr. W. King Grant

Gentlemen:

This letter will serve to amend our Reinsurance Agreement dated June 28, 1957 and amending letters thereto.

As of January 2, 1962 the following subsidiaries of Southern Discount Company shall be included under the terms and conditions of the Reinsurance Agreement and Amendments thereto:

Southern Discount Co., 220 Hasley Bldg., Atlanta, Ga.

Southern Discount Co., 204 Boswell St., Marietta, Ga.

Southern Discount Co., 329 Cotton Ave., Macon, Ga.

Southern Discount Co., 140 Broad Ave., Albany, Ga.

Southern Discount Co., 1105 Market St., Warner Robins, Ga.

Southern Discount Co. #2, 385 Second St., Macon, Ga.

Southern Discount Co., 219 Main St., Barnesville, Ga.

Southern Discount Co., 106 S. Main St., Ft. Valley, Ga.

Effective January 2, 1962, Article V of said Reinsurance Agreement is amended to provide that with regard to business emanating from offices of Southern Discount Company listed above, premiums ceded shall be 40% less than the premiums shown in the addendum to the Reinsurance agreement dated May 28, 1959.

It is further agreed and understood that if the combined net premiums written during the calendar year 1961 and thereafter exceeds $800,000, the ceding commission shall be reduced ½ of 1%.

All other terms and conditions of said Reinsurance Agreement and Addenda shall remain in full force and effect.

Please indicate your acceptance of the foregoing by executing below in the space provided and retaining a copy for your files.

/s/ R. Kirk Landon
R. KIRK LANDON, President

Accepted this 8th day of January, 1962.

CONSUMER LIFE INSURANCE COMPANY

By /s/ [Illegible]
Controller

Mr. W. King Grant,
Consumer Life Insurance Company
919 West Peachtree Street, N. E.
Atlanta, Georgia

Dear King:

This letter will serve to amend our Reinsurance Agreement dated June 20, 1957, and amending letters thereto.

As of the 8th day of December, 1965, the subsidiaries of Southern Discount Company, located in the State of Tennessee, shall be included under the terms and conditions of the Reinsurance Agreement and Amendments thereto.

Effective the 8th day of December, 1965, ARTICLE V of said Reinsurance Agreement is amended as follows with regard to the business originating under the Southern Discount Subsidiary, State of Tennessee.

In consideration of the Reinsurance, as set forth in ARTICLE I, the American Bankers agrees to pay monthly to Consumer Life, based on the statements set forth in ARTICLE III for the preceding month, and payable at the same time: (1) Eighty-five per cent (85%) of the premiums collected, less any premiums returned on all Life policies, and (2) Eighty-five per cent (85%) of the premiums earned on Health and Accident policies, and there shall be deducted (i) the cumulative total losses and the loss expenses paid, and (ii) all of the company's reserves and all claims outstanding, including incurred but unreported claims, and (iii) all commissions paid by the Company to the Agent cumulative, and (iiii) the cumulative total of all amounts previously paid to the Agent.

Should the remainder be a minus figure, the minus figure shall be paid by Consumer Life Insurance Company to American Bankers Life Assurance Company before the 30th day of the month after such statements are submitted.

All others terms and conditions of said Reinsurance Agreement and Addenda shall remain in full force and effect.

Please indicate your acceptance of the foregoing by executing below in the space provided, retaining a copy for your files.

/s/ George D. Floyd
GEORGE D. FLOYD,
Vice President

Accepted this 25th day of January, 1966.

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant, President
W. KING GRANT

[PLAINTIFF'S EXHIBIT 3]

REINSURANCE AGREEMENT
between
CONSUMER LIFE INSURANCE COMPANY
of Phoenix, Arizona

hereandafter referred to as the "Ceding Company", party of the first part.

and

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA,
of Miami, Florida,

hereandafter referred to as "American Bankers", party of the second part.

Article I

BASIS OF REINSURANCE

1. On and after the effective date hereof, the Ceding Company's liability under Credit Accident and Sickness policies issued directly by the Ceding Company on the policy forms specified in Schedule A, attached hereto, shall be reinsured automatically to the degree and in the manner hereinafter specified.

2. The reinsurance liability of American Bankers during 1962 shall be 80% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced at the option of the ceding company at the beginning of each subsequent calendar year.

3. Reinsurance hereunder shall apply and be subject to all benefits and limitations included in policies issued by the Ceding Company and subject to reinsurance hereunder.

Article II

MOTION OF CESSION

1. Reinsurance of Credit Accident and Sickness insurance issued or renewed by the Ceding Company

on and after the effective date of this Agreement shall be effected by the Ceding Company's mailing to American Bankers a reinsurance cession on a form of which a sample is attached hereto and marked Schedule B, not later than the twentieth day following the last day of the calendar quarter covered by the reinsurance cession. The liability of American Bankers shall:

(a) commence as of the effective dates of the reinsurance premiums, and

(b) continue only for the period covered by the reinsurance premiums.

2. In no event shall the reinsurance be in force and binding unless the policy issued by the Ceding Company to the insured is in force.

Article III

REINSURANCE PREMIUMS

1. The reinsurance premiums to be paid the American Bankers by the Ceding Company shall be the premiums charged the insured by the Ceding Company during the calendar quarter for the coverage reinsured.

2. The American Bankers will pay to the Ceding Company a commission of 50% of reinsurance premiums received, as specified in this Article, on reinsurance hereunder.

Article IV

OVERSIGHTS

1. American Bankers shall be bound as the Ceding Company is bound, and it is expressly understood and agreed that if non-payment of premiums within the time specified or failure to comply with the terms of this Agreement is shown to be unintentional and the result of misunderstanding or oversight on the part of either the Ceding Company or American Bankers, both the Ceding Company and American Bankers shall be

restored to the positions they would have occupied had no such error or oversight occurred.

Article V

PAYMENT OF CLAIMS

1. At the end of each calendar quarter American Bankers shall reimburse the Ceding Company for American Bankers share of all claim payments made by the Ceding Company during the calendar quarter on policies reinsured hereunder.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

Article VI

EXPERIENCE REFUNDS

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund = (P+Co+E+Cl)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

2. If P+Co+E+Cl is negative for a given calendar quarter such negative amount will be treated as an addi-

tion to the incurred claims in calculating the Experience Refund for the following calendar quarter.

Article VII

TAXES, ASSESSMENTS AND EXPENSES

Neither party hereto shall be liable to the other for taxes, assessments, or any expenses resulting from reinsurance hereunder. The Ceding Company shall furnish the American Bankers with all necessary information so that American Bankers will not be required to perform any office work other than the regular bookkeeping entries made in connection with reinsurance accounting.

Article VIII

INSPECTION OF RECORDS

American Bankers shall have the right at any reasonable time to inspect at the office of the Ceding Company all books and documents relating to the reinsurance under this Agreement.

Article IX

INSOLVENCY

1. In the event of insolvency of the Ceding Company, all reinsurance in force shall be payable to its liquidator or receiver without diminution because of the insolvency of the Ceding Company by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is understood, however, that in the event of the insolvency of the Ceding Company, the liquidator, receiver or statutory successor of the Ceding Company shall be given written notice of the pendency of a claim against the Ceding Company on the policy reinsured with a reasonable time after such claim is filed in the insolvency proceedings and that during the pendency of such claim the American Bankers may investi-

gate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to the Ceding Company or its liquidators or receiver or statutory successor.

2. The expense thus incurred by American Bankers shall be chargeable against the Ceding Company as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the Ceding Company solely as a result of the defense undertaken by American Bankers.

Article X

SETTLEMENT OF CLAIMS

1. American Bankers shall be liable to the Ceding Company for the benefits covered by reinsurance hereunder to the same extent as the Ceding Company is liable to the insured for such benefits and all reinsurance shall be subject to the terms and conditions of the particular form of policy under which the Ceding Company shall be liable.

2. It is hereby understood and agreed that the American Bankers shall be liable only for claims incurred on or after the effective date hereof.

3. Whenever a claim is made under a policy of the Ceding Company, which has been reinsured hereunder, it shall be taken and considered by American Bankers to be a claim for the amount of reinsurance on such risk and American Bankers shall abide the issue as it shall be settled by the Ceding Company and shall pay the amount of reinsurance covered by the policy of reinsurance when the Ceding Company shall settle with the Claimant.

4. Any suit or claim may be contested or compromised on the part of the Ceding Company and in case of a reduction of the claim made upon the Ceding Company, American Bankers and the Ceding Company shall participate in such reduction in the ratio that each company's net liability bore to the total net liability prior

to the reduction of the claim. Any unusual expenses incurred by the Ceding Company in defending or investigating any claims or taking up or rescinding any policy reinsured hereunder aside from routine investigations and other expenses incidental to the settlement of claims shall be shared in the same proportion.

5. In every case of loss, copies of proofs obtained by the Ceding Company shall likewise be taken as sufficient by American Bankers and copies thereof, together with a statement showing the amount paid on such claim by the Ceding Company shall be furnished to American Bankers before payment shall be demanded of it.

Article XI

ARBITRATION

1. All disputes and differences between the two contracting parties upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this treaty from the standpoint of practical business and equity rather than from that of the strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitrators which is to be held in the City of Miami, Florida, shall consist of three arbitrators who must be officers of life insurance companies other than the two parties of this Agreement. One of the arbitrators is to be appointed by the Ceding Company, the second by American Bankers and the third is to be selected by those two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators be unable to agree upon the choice of a third, the appointment shall be left to the counsel for the Consumer Credit Insurers Association.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration, including the fees of the arbitrators, shall

be borne by the losing party unless the arbitrators shall decide otherwise.

XII

PARTIES TO AGREEMENT

This is an agreement solely between the Ceding Company and American Bankers. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Bankers and the insured or the beneficiary under any policy of the Ceding Company which may be reinsured hereunder.

Article XIII

DURATION

1. This agreement shall be effective as of the 1st day of March 1962, and may be terminated as of the end of any calendar quarter by either party giving to the other not less than 30 days' written notice.

2. Upon termination, as provided in this Article, the Ceding Company shall, within 30 days of the termination date, supply American Bankers with the information necessary to calculate the final experience refund as of the termination date. Payment of (a) the final experience refund, (b) the unearned premium reserve held by American Bankers less unearned commissions thereon, and (c) payment of the claim reserve held by American Bankers.

IN WITNESS WHEREOF the parties hereto have caused this Agreement to be executed in duplicate this 18th day of April 1962.

CONSUMER LIFE INSURANCE COMPANY

By /s/ [Illegible]
President

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ [Illegible]

—SCHEDULE A—

Plans subject to Reinsurance hereunder:

Application to

CONSUMER LIFE INSURANCE COMPANY

Policy No. CL 1004

Executive Office:
919 West Peachtree St., N.E.
Atlanta 9, Georgia

Home Office:

Phoenix, Arizona

(Herein called the Company)

[Form Omitted in Printing]

This copy to Insurance Co.

If this policy is designated above as Level Term Life then,

Upon receipt at its Executive Office of due proof of the death of the Insured, the Company will pay to the first beneficiary the amount of any indebtedness owing by said Insured to said first beneficiary at the date of the death of said Insured, not exceeding said amount of insurance stipulated above; and to the second beneficiary, if then living, otherwise to the estate of said Insured, the amount by which said stipulated amount of insurance exceeds said indebtedness, if any, or, if there be no such indebtedness, the full amount of insurance stipulated above.

If this policy is designated above as Reducing Term Life then,

Upon receipt at it Executive Office of due proof of the death of the Insured, the Company will pay an amount determined by progressively diminishing the above initial amount of Life insurance by an equal reduction at the end of each policy month after the date hereof. The amount of each such monthly reduction shall be determined by dividing the above initial amount of

Life Insurance by the number of months of the term of this policy. Said payable amount determined as above shall be paid to the first beneficiary as its interest may appear. If the amount payable exceeds the interest of the first beneficiary the balance of said payable amount shall be paid to the second beneficiary if then living otherwise to the estate of the Insured. As referred to in this policy, the interest of the first beneficiary shall be the amount of indebtedness if any, owing by the insured to the first beneficiary at the time of death.

This policy shall constitute the entire contract between the parties and shall be incontestable from the date of issue except for non-payment of premium. All statements made by the Insured shall in the absence of fraud, be deemed representations and not warranties and no such statement shall avoid the policy. No alteration of this policy or waiver of any of its conditions shall be valid unless endorsed hereon and signed by an officer of the Company. No agent is authorized to modify, alter or enlarge this policy, or to bind the Company by any promise or undertaking. No assignment of this policy shall be binding on the Company until it is filed with the Company at its Executive Office. The Company assumes no responsibility as to the validity of any assignments.

If the Insured shall, within one year from the date of this policy, commit suicide while this policy is in force, the amount of recovery hereunder shall be limited to the amount of the premium paid or the policy reserve or the amount payable tc the first beneficiary as its interest herein may appear, whichever may be the greater.

SCHEDULE B

Reinsurance Cession #.....

for Calendar Quarter ending .....

		% Reinsured
Premiums received during current quarter	$.....	$.....
less Premiums due and unpaid at the end of previous quarter	$.....	$.....
plus Premiums due and unpaid at end of current quarter	$.....	$.....
Incurred Premiums for current calendar quarter	$.....	$.....
less Unearned Premiums at beginning of quarter	$.....	$.....
plus Unearned Premiums at end of quarter	$.....	$.....
Earned Premiums for current quarter	$.....	$.....
Claims paid during quarter	$.....	$.....
plus Claim Reserve at end of quarter		
Due and unpaid claims	$.....	$.....
Incurred but unreported claims	$.....	$.....
Present value of amounts not yet due	$.....	$.....
Total Claim Reserve	$.....	$.....
less Claim Reserve at beginning of quarter	$.....	$.....
Incurred claims for current quarter	$.....	$.....

AMERICAN BANKERS LIFE
ASSURANCE COMPANY OF FLORIDA

P.O. Box 4980
600 Brickell Avenue
Miami 32, Florida
Telephone:
FRanklin 3-8664

ADDENDUM TO REINSURANCE AGREEMENT

THIS AGREEMENT, made this 2nd day of December, 1964, and effective the 1st day of October, 1964, by and between CONSUMER LIFE INSURANCE COMPANY OF PHOENIX, ARIZONA, hereinafter designated as "Ceding Company" and AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA, a corporation duly organized and existing under and by virtue of the laws of the State of Florida and having its executive office in the City of Miami, and State of Florida, hereinafter designated as "Company".

WITNESSETH

WHEREAS, the Company and the Ceding Company entered into a Reinsurance Agreement on the 1st day of March, 1962; and

WHEREAS, the parties are mutually desirous of amending said Agreement as hereinafter set forth.

NOW, THEREFORE, IT IS MUTUALLY UNDERSTOOD AND AGREED AS FOLLOWS:

1. The terms and conditions of said Reinsurance Agreement are incorporated within the terms of this Agreement.

2. Article I, Paragraph (2) is hereby amended to read:

   The reinsurance liability of American Bankers shall be 65% of each policy issued by the Ceding Company; thereafter, with respect to new business, such reinsurance liability may be reduced

at the option of the Ceding Company at the beginning of each subsequent calendar year.

3. All other conditions are to remain the same.

Witnesses:

/s/ [Illegible]

/s/ [Illegible]

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ [Illegible]
"Company"

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant
"Ceding Company"

AMENDMENT TO Reinsurance Agreement between Consumer Life Insurance Company of Phoenix, Arizona, and American Bankers Life Assurance Company of Florida, of Miami, Florida, dated April 18, 1962.

Article VI of above mentioned Reinsurance Agreement is hereby amended to read as follows:

Article VI

EXPERIENCE REFUNDS

1. Reinsurance ceded hereunder shall be eligible for an Experience Refund. The Experience Refund for a given calendar quarter shall be computed as follows:

Experience Refund — (P+Co+E+Cl+N)

where P = earned reinsurance premiums during the calendar quarter as determined by American Bankers.

Co = earned reinsurance commissions during the calendar quarter as determined by American Bankers.

E = an expense, profit, and contingency charge equal to .03P.

Cl = incurred reinsurance claims during the calendar quarter as determined by American Bankers.

N = negative carry-forward from prior quarter.

2. If a negative amount is obtained from the calculation of the Experience Refund for a given calendar quarter, such negative amount will be carried forward in calculating the Experience Refund for the following calendar quarter, provided, however, that any unamortized balance of such negative carry-forward will be dropped

from the refund calculation after 20 quarters. The "first-in, first-out" principle will apply to the unamortization of two or more negative carry-forwards arising from the experience of different calendar quarters.

IN WITNESS WHEREOF the parties hereto have caused this Amendment to be executed in duplicate this 29th day of December, 1964, and to be effective for calculating the Experience Refund due for the calendar quarter ending December 31, 1964.

CONSUMER LIFE INSURANCE COMPANY

By /s/ W. King Grant Jr.

AMERICAN BANKERS LIFE ASSURANCE COMPANY OF FLORIDA

By /s/ George Floyd

[PLAINTIFF'S EXHIBIT 10]

INSURANCE DEPARTMENT OF ARIZONA
PHOENIX, ARIZONA

REPORT OF EXAMINATION OF THE CONSUMER LIFE INSURANCE COMPANY PHOENIX, ARIZONA AS OF APRIL 30, 1959

GUY L. HAMMETT, SENIOR EXAMINER

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Atlanta, Georgia
June 23, 1959

Honorable G. A. Bushnell, Director
Insurance Department of Arizona
718 West Glenrosa
Phoenix, Arizona

Dear Sir:

Pursuant to your instructions and in conformity with the provisions of the Insurance Laws of the State of Arizona, an examination has been made of the books, records, administrative affairs and financial condition of the

CONSUMER LIFE INSURANCE COMPANY

hereinafter known as such, or as the "Company", at its Executive Office, located in Suite 227 at 919 West Peachtree Street, Atlanta 9, Georgia. Report of such examination is herewith respectfully submitted.

SCOPE OF EXAMINATION

This is the first or initial examination of the Company and covers the period from the date of admittance to the State of Arizona, July 12, 1957, to April 30, 1959, with a review of such subsequent transactions as had bearing on the period under review.

Income and disbursement items were checked sufficiently to determine accountability and proper distribution. Working trial balances were prepared for the years ended December 31, 1957 and December 31, 1958, and traced into the annual statements prepared and filed by the Company with your Department. The assets were inventoried and valued and the liabilities were determined as of April 30, 1959 resulting in the stated financial condition at that date. A general survey was made of the Company's managerial and investment policies and practices and the recorded minutes and various deliberations of its Corporate Bodies were carefully reviewed.

HISTORY—OBJECTS

History: The Consumer Life Insurance Company was originally incorporated under the laws of the State of Arizona on July 1, 1957 and commenced business as a Domestic Limited Stock Life and Disability Company with $25,000.00 of capital stock issued. On March 19, 1959, the Company issued additional capital stock with a par value of $175,000.00 thereby qualifying as a Life and/or Disability Company.

Objects: The objects of the Company, as set out in Article III of its Articles of Incorporation, are quoted, in part, as follows:

> "The nature of the business, or objects or purposes to be transacted, promoted or carried on are:
>
> (a) To insure in its own and proper corporate name, the lives of persons and all insurance appertaining thereto, including, but not limiting the generality of the foregoing: term, industrial, retirement income, ordinary, modified, single premium, limited payment, group and all other types and forms of contracts of insurance upon or relating to the lives of persons in connection with the extension of credit to such persons.
>
> (b) To reinsure all or part of any risk, class of risks, or all of the risks of the Company with any other insurance company or companies, and to accept such reinsurance from any other insurance company or companies, as allowed by law."

CAPITAL STOCK AND PAID-IN SURPLUS

Article IV of the Articles of Incorporation authorized the issuance of one million (1,000,000) shares of common capital stock at a par value of one (1) dollar per share.

On July 2, 1957 the Company issued 25,000 shares of its common capital stock to the Southern Discount Company and received $38,000.00 for such stock, with $13,-

000.00 being credited to surplus paid-in and $25,000.00 being credited to capital paid-up. At a special meeting of the Board of Directors, held February 6, 1959, a resolution was passed to pay a stock dividend of $175,000.00. On March 19, 1959 a stock certificate was issued to the Southern Discount Company for 175,000 shares of the common stock of the Company. This was accomplished by transferring the $13,000.00 of paid-in surplus and an additional $162,000.00 from earned surplus to the capital paid-up account.

MANAGEMENT AND CONTROL

Stockholders: The Company is operated strictly on the proprietary plan, each stockholder being entitled to one vote for each share of stock owned.

The annual meeting of the stockholders shall be held on the third Tuesday in August of each year. Notice of the time and place for the annual meeting of the stockholders shall be mailed at least ten (10) and not more than fifty (50) days prior to the meeting. Special meetings of the stockholders may be called by the Chairman of the Board of Directors, or by the President, or in his absence, by any Vice-President, or by a majority of the Board of Directors. Notice of special meetings of the Stockholders shall be mailed at least five (5) and not more than fifty (50) days prior to the meeting. Business transacted at all special meetings shall be confined to the objects stated in the notice and call. A quorum at any meeting of the stockholders shall consist of a majority of the stock issued and outstanding.

According to the minutes reviewed annual meetings of the stockholders were held August 20, 1957 and August 19, 1958. There is no record of any special meetings of the Stockholders.

Directors: The business of the Company is managed by its Board of Directors.

Directors are elected by the Stockholders at each annual meeting, for a term of one year and shall consist of not less than five (5) nor more than fifteen (15) members. Vacancies may be filled by the remaining Directors until the next annual meeting of the Stockholders.

The annual meeting of the Board of Directors shall be held on the third Tuesday in August of each year. Regular meetings of the Board may be held without notice. Special meetings of the Board of Directors may be called by the President or Secretary or on the written request of two Directors. Written notice of special meetings of the Board of Directors shall be given to each Director at least three (3) days before the date of the meeting. At all meetings of the Board a majority of the whole Board, but not less than three (3) Directors, shall constitute a quorum.

According to the minutes the Board of Directors have held annual meetings on August 20, 1957 and August 19, 1958. Other meetings of the Board of Directors have been as follows:

July 1, 1957
July 3, 1957
September 26, 1957
January 14, 1958
January 27, 1958
February 26, 1958
April 4, 1958
April 8, 1958
June 11, 1958
November 3, 1958
November 10, 1958
January 2, 1959
January 30, 1959
February 6, 1959
March 5, 1959

The incorporators of the Company as shown in Article IV of the Articles of Incorporation were as follows:

W. J. Richmond	5218 E. Roma	Phoenix, Arizona
Ann O. Richmond	5218 E. Roma	Phoenix, Arizona
Amil J. Ajamie	5717 No. 16th St.	Phoenix, Arizona
Eleanor G. Bookman	4231 No. 10th St.	Phoenix, Arizona
Tom Roof	411 No. Central Ave.	Phoenix, Arizona

Article X of the Articles of Incorporation list the following persons to serve as the first members of the Board of Directors:

W. King Grant	1720 W. Wesley Rd., N.W.	Atlanta, Ga.
Jessie Y. Lynn	R. F. D. #4	Douglasville, Ga.
Byron L. Lassiter	806 Sherwood Rd., N.E.	Atlanta, Ga.
Wilburn F. Carter, Jr.	531 N. College Avenue	Decatur, Ga.
Richard P. Fraser	3285 Peachtree Rd., N.E.	Atlanta, Ga.

The above named Directors were reelected at the annual meeting of the Stockholders held August 20, 1957 and August 19, 1958 and are now serving terms that will expire with the annual meeting of the Stockholders to be held on August 18, 1959.

Section 10 of Article III of the Articles of Incorporation states that the Board of Directors may be paid expenses and compensation for attendance at meetings. However, to the date of this examination, the Directors have never received any payment for attendance at meetings.

Officers: Section 1 of Article VI of the By-Laws reads as follows:

> "The officers of the corporation shall be chosen by the board of directors and shall be a president, vice-president, a secretary, a treasurer and an assistant secretary. The board of directors may also choose additional vice-presidents, and one or more assistant secretaries, and assistant treasurers. Two or more offices may be held by the same person, except that where the offices of president and secretary are held by the same person, such person shall not hold any other office and except that no one person can hold the offices of president and any vice-president at the same time."

From the inception of the Company to the date of this examination, the officers have been as follows:

W. King Grant	President
Wilburn F. Carter, Jr.	Vice-President
Jessie Y. Lynn	Secretary-Treasurer
William J. Richmond	Assistant Secretary

None of the officers receive any salaries, as such, for the performance of their duties.

CORPORATE RECORDS

Articles of Incorporation: There is no indication in the minute book that the Company has ever changed or amended their Articles of Incorporation.

By-Laws: A review of the minute book indicates that apparently the Company has never made any changes in their original By-Laws.

Minutes: The minute book is of the usual loose leaf type, neatly typewritten and appears to reflect the acts and deliberations of its Stockholders and its Board of Directors.

FIDELITY BONDS

Currently the Company is protected by a Small Loan Companies Bond, jointly with associated Companies, #4031916 issued by the Fireman's Insurance Company, San Francisco, California, covering all employees, in the amount of $100,000.00.

STATUTORY DEPOSIT

At April 30, 1959, the Company had on deposit with the Treasurer of the State of Arizona, securities in the par value amount of $102,500.00.

TERRITORY AND PLAN OF OPERATION

Territory: This is an Arizona Corporation, authorized to do business in the State of Arizona, only.

Plan of Operation: From the date of organization to April 30, 1959, the Company has never established an agency organization but secures its business wholly from assuming reinsurance. Currently the Company receives the full premiums received by the writing Company and allows a ceding commission of 9½% for such cession, plus variable allowances for writing commissions. The writing Company cedes both life insurance and accident and health policies. All such reinsurance assumed is

ceded to the Company by the American Bankers Life Assurance Company of Florida, Miami, Florida.

GROWTH OF COMPANY

The growth of the Company from July 12, 1957 through April 30, 1959 is presented in the following manner:

Year	Premiums Earned	Policies In Force	Insurance In Force
1957	$127,660.81	5,227	$1,907,345.00
1958	369,931.98	14,024	6,081,859.00
April 30, 1959	133,845.96	17,352	7,406,042.00

A further analysis of the growth of the Company, regarding Assets, Liabilities, Capital and Surplus, will be found in a subsequent section of this report, captioned COMPARATIVE FINANCIAL STATEMENT.

MORTALITY OR LOSS EXPERIENCE

The mortality or loss experience of the Company from the date of organization to April 30, 1959 is exhibited as follows:

Year	Life	Accident and Health	Total
1957	$ 1,002.00	$ 3,232.60	$ 4,234.60
1958	17,272.87	44,071.16	61,344.03
April 30, 1959	11,160.50	25,885.98	37,046.03

The above stated amounts are based on actual payments during the period. At April 30, 1959 there was outstanding and unpaid death claims in the amount of $1,575.00 and accident and health claims in the amount of $13,776.65 for a grand total of $15,351.65.

POLICY FORMS AND UNDERWRITING PRACTICES

Policy Forms: From the date the Company commenced business, July 12, 1957, to April 30, 1959 the

Company has never issued or written policies direct and secures its business through a reinsuring agreement with American Bankers Life Assurance Company of Florida, Miami, Florida.

All risks assumed by the Company, under the reinsuring agreement, consist entirely of credit insurance for life and accident and health. At the option of the policyholder he may carry life insurance without having accident and health coverage and he may carry accident and health insurance without having life insurance coverage.

This credit insurance is issued, on a voluntary basis, to secure funds advanced by a lending institution with the lender being named first beneficiary in the policy with any residue after the indebtedness has been liquidated reverting to a second beneficiary, named in the policy, by the applicant.

All such policies are usually issued for the number of months the borrower elects to amortize the loan, and in such cases, the full amount of insurance is in force until such number of months elapse. In some few instances the coverage is on a reducing term basis.

The policies issued by the American Bankers Life Assurance Company of Florida, and reinsured by the Company, are briefly described, as follows:

> "Single Premium, Non Participating Level Term Life and Accident and Sickness Insurance policy."
>
> "Single Premium, Non Participating, Non Cancellable, Non Renewable, Reducing Term Life and Accident and Sickness Insurance Policy."

Risks assumed by the Company are furnished by the ceding Company through a duplicate copy of the original application form bearing the same number as the actual policy that is issued.

An inspection of a representative number of the duplicate applications in the Company's possession indicates that apparently no risks are assumed in excess of the limitation contained in Section 8 of Article 22 Arizona Insurance Code, 1955.

Underwriting Practices: Currently the Company has no Underwriting Department and accepts all risks as they are ceded to them. As all of this is credit insurance the lending Company apparently receives a credit report before making the loan thereby accomplishing the underwriting, to this extent, when the policy is issued.

All policies are issued on a non-medical basis.

REINSURANCE

Under a reinsuring agreement with the American Bankers Life Assurance Company of Florida the Company assumes all of certain risks 100% on an automatic basis. No portion of the risks assumed are ceded to any other Company.

CLAIMS

American Bankers Life Assurance Company of Florida makes all claim settlement and deducts all such payments from the monthly remittance made to the Company in payment of risks ceded.

ACCOUNTS AND RECORDS

The accounts and records of the Company consist of the usual income and disbursement journals, general ledger and necessary subsidiary records.

Since the Company secures all of its business through a reinsuring agreement the actual records necessary are limited in number and can be handled with a minimum of personnel.

The Company shares offices with associated Companies and the same employees handle work for each of the Companies. One of the associated Companies pays all the salaries and bills the Company for their pro-rata share of this expense.

The books were reviewed for the period under examination and the accounting has been accepted by the examiner.

FINANCIAL STATEMENTS

Immediately following will be found a statement of Assets, Liabilities, Surplus and Other Funds for the period ended April 30, 1959, as developed by this examination.

Supplemental exhibits for the period ended April 30, 1959 and a comparative financial statement for the years ended December 31, 1957 and 1958 and the period ended April 30, 1959 are also included in this report following the financial statement. Such exhibits are as follows:

Summary of Operations (Accrual Basis)
Surplus Account

Exhibit 1—Part 1 Premiums
Part 2 Commissions Incurred

Exhibit 3—Interest, Dividends and Real Estate Income

Exhibit 5—General Expenses

Exhibit 6—Taxes, Licenses and Fees

Exhibit 12—Reconciliation of Ledger Assets
Reconciliation Between Years

Exhibit 13—Assets

Comparative Financial Statement

ASSETS

Bonds		$ 29,160.29
Savings and loan certificates		50,000.00
Cash and bank deposits		326,483.30
Cash and invested assets	$405,643.59	
Life insurance premiums uncollected		12,798.93
Accident and health premiums due and unpaid		51,165.87
Interest and other investment income due and accrued		1,006.23
Total		$470,614.62

LIABILITIES, SURPLUS AND OTHER FUNDS

Aggregate reserve for life policies and contracts		$ 35,483.38
Policy and contract claims—life		1,575.00
Policy and contract claims—accident and health		13,776.65
Commissions to agents due or accrued		18,653.71
Taxes, licenses and fees due or accrued		53,678.88
Mandatory security valuation reserve		39.58
Total Liabilities (Except Capital)		$123,207.20
Capital paid-up	$200,000.00	
Unassigned surplus	147,407.42	
Surplus and regards policyholders		347,407.42
Total		$470,614.62

SUMMARY OF OPERATIONS
(ACCRUAL BASIS)

Premium considerations—life	$ 47,748.52
Premium considerations—accident and health	86,097.44
Net investment income	680.37
Total	$134,526.33
DEDUCT:	
Death benefits	$ 5,688.05
Benefits under accident and health policies	23,746.82
Increase in aggregate reserve for policies and contracts	(12,014.62)
Subtotal	$ 17,420.25
Commissions on premiums	26,892.81
General insurance expenses	1,550.48
Insurance taxes, licenses and fees	20,300.36
Increase in loading on uncollected premiums	(2,023.65)
Total	$ 64,140.25
Net gain from operations	$ 70,386.08

SURPLUS ACCOUNT

		Dividends to stockholders	$175,000.00
		Increase in mandatory security valuation reserve	39.58
Unassigned surplus December 31, previous year	$252,060.92	Unassigned surplus April 30, current year	147,407.42
Net gain from operations	70,386.08		
Total	$322,447.00		$322,447.00

EXHIBIT 1

Part 1 Premiums

	Total	Life Insurance	Accident and Health
Single Premium—Credit			
Uncollected	$ 76,763.74	$25,597.87	$ 51,165.87
Collected during year	146,323.57	51,795.83	94,527.74
Total	$223,087.31	$77,393.70	$145,693.61
Less uncollected previous year	89,241.35	29,645.18	59,596.17
Total premiums earned to April 30, 1959	$133,845.96	$47,748.52	$ 86,097.44
PART 2 Commissions Incurred			
Single premium—credit	$ 26,892.81	$ 9,886.07	$ 17,006.74

EXHIBIT 3—
INTEREST, DIVIDENDS AND REAL ESTATE INCOME

	Collected During Year	Interest Accrued	Accrued Previous Year	Earned During Year
Interest on bonds	$(100.86)	$ 285.41	—0—	$184.55
Dividends on stock	—0—	408.32	—0—	408.32
Interest on bank deposits	525.00	312.50	750.00	87.50
Totals	$ 424.14	$1,006.23	$750.00	$680.37

Interest on bonds includes $219.61 paid for accrued interest on purchase

EXHIBIT 5—GENERAL EXPENSES

	Life	Accident and Health	Total
Rent	$ 72.00	$ 128.00	$ 200.00
Salaries and wages	72.00	128.00	200.00
Legal fees and expenses	45.00	80.00	125.00
Fees of public accountants and consulting actuaries	331.61	589.52	921.13
Traveling expenses	36.00	64.00	100.00
Stationery and office supplies	1.57	2.78	4.35
General Expenses Paid	$ 558.18	$ 992.30	$ 1,550.48

EXHIBIT 6—TAXES, LICENSES AND FEES

State insurance department licenses and fees	$ 25.20	$ 44.80	$ 70.00
U.S. federal income taxes	6,808.00	13,192.00	20,000.00
All other taxes	79.20	140.80	220.00
Taxes, Licenses and Fees Paid	$ 6,912.40	$13,377.60	$20,290.00
Taxes, licenses and fees unpaid April 30, current year	18,664.56	35,014.32	53,678.88
Taxes, licenses and fees unpaid December 31, previous year	18,268.76	35,399.76	53,668.52
Taxes, licenses and fees incurred during period ended April 30, 1959	$ 7,308.20	$12,992.16	$20,300.36

EXHIBIT 12—RECONCILIATION OF LEDGER ASSETS

INCREASES IN LEDGER ASSETS

Premiums on life policies	$ 51,795.83
Accident and health cash premiums	94,527.74
Interest and dividends income	424.14
Increase of paid-up capital during period	175,000.00
Total Increases in Ledger Assets	$321,747.71

DECREASES IN LEDGER ASSETS

Policy and contract claims—life	$11,160.05	
Policy and contract claims—accident and health	25,885.98	
Total Paid Policyholders		$ 37,046.03
Commissions to agents—life	$ 4,920.61	
Commissions to agents—accident and health	8,980.13	
Total Commission to Agents		13,900.74
General expenses—life	$ 558.18	
General expenses—accident and health	992.30	
Total General Expenses		1,550.48
Taxes, licenses and fees—life	$ 6,912.40	
Taxes, licenses and fees—accident and health	13,377.60	
Total Taxes, Licenses and Fees		20,290.00
Paid stockholders for dividends—stock		175,000.00
Total Decreases in Ledger Assets		$247,787.25

RECONCILIATION BETWEEN YEARS

Amount of ledger assets December 31st of previous year	$331,683.13
Increase of ledger assets during period	73,960.46
Total Ledger Assets April 30, 1959	$405,643.59

EXHIBIT 13—ASSETS

	Ledger Assets	Non-Ledger Assets	Net Admitted Assets
Bonds	$ 29,160.29	$ —0—	$ 29,160.29
Savings and loan certificates	50,000.00	—0—	50,000.00
Deposits in banks	326,483.30	—0—	326,483.30
Life insurance single premiums uncollected (excluding $12,798.94 loading)	—0—	12,798.93	12,798.93
Accident and health premiums due	—0—	51,165.87	51,165.87
Interest due and accrued	—0—	1,006.23	1,006.23
Totals	$405,643.59	$64,971.03	$470,614.62

COMPARATIVE FINANCIAL STATEMENT
ASSETS

	1957	1958	April 30, 1959
Bonds	$ —0—	$ —0—	$ 29,160.29
Savings and loan certificates	—0—	—0—	50,000.00
Cash and bank deposits	92,888.12	331,683.13	326,483.30
Life insurance premiums uncollected	19,772.42	14,822.59	12,798.93
Accident and health premiums due	35,746.07	59,596.17	51,165.87
Investment income accrued	375.00	750.00	1,006.23
Totals	$148,781.61	$406,851.89	$470,614.62

LIABILITIES, SURPLUS AND OTHER FUNDS

Aggregate reserve for life policies	$ 16,700.74	$ 47,498.00	$ 35,483.38
Policy claims outstanding—life	—0—	7,047.00	1,575.00
Policy claims outstanding—accident and health	2,612.50	15,915.81	13,776.65
Commissions due agents	4,468.26	5,661.64	18,653.71
Taxes, licenses and fees accrued	674.78	53,668.52	53,678.88
Mandatory security valuation reserve	—0—	—0—	39.58
Total Liabilities (Except Capital)	$ 24,456.28	$129,790.97	$123,207.20
Capital paid-up	25,000.00	25,000.00	200,000.00
Unassigned surplus	99,325.33	252,060.92	147,407.42
Totals	$148,781.61	$406,851.89	$470,614.62

COMMENTS ON FINANCIAL STATEMENT
ASSETS

Bonds $29,160.29

The bond portfolio of the Company at April 30, 1959, consisted of the following:

	Actual Cost	Par Value	Book Value
Georgia State School Building Authority 3%, due 3-1-72	$ 9,076.75	$10,000.00	$ 9,076.75
City of Phoenix, Arizona, Water, 3% due 10-1-69	9,533.46	10,000.00	9,533.46
Cherokee County Georgia, Water Authority, 4¾%, due 10-1-69	5,322.12	5,000.00	5,322.12
City of Moultrie, Georgia, Water Sewerage Revenue, 3¾%, due 4-1-70/69	5,227.96	5,000.00	5,227.96
Totals	$29,160.29	$30,000.00	$29,160.29

A certificate received from the office of the Treasurer of the State of Arizona, stated that the first three items listed above, with a par value of $25,000.00, were on deposit with that office at April 30, 1959. The last item listed above was verified by actual inspection and count at the Company's office, in the presence of the Controller of the Company on June 10, 1959.

All of the bonds owned by the Company are eligible investments as defined in Article 9 of the Arizona Insurance Code, 1955.

Prior to 1959 the Company had made no investment in bonds and since the bonds had been held only a short time before April 30, 1959, they were not amortized. However, the Company is aware of the fact that an amortization schedule must be prepared and used in the annual statements.

Interest accrued in the amount of $285.41 was computed by the examiner and included in Exhibit 2, in this report.

Savings and loan certificates	$50,000.00

The savings and loan certificates owned by the Company, at April 30, 1959, was certificates issued by 5 federally insured savings and loan associations, in the amount of $10,000.00 each. Three of those associations are located in Phoenix, Arizona and the other two are located in Atlanta, Georgia.

Verification of those certificates was received in a certificate from the office of the Treasurer of the State of Arizona stating that they were on deposit with that office at April 30, 1959.

Interest accrued in the amount of $408.32 was computed by the examiner and included as an admitted asset in a foregoing section of this report.

Cash and bank deposits	$326,483.30

At April 30, 1959, the Company had certificates of time deposits in three banks in Phoenix, Arizona totaling $27,500.00, with an interest accretion of 3% per annum. The balance of $298,983.30 represents balances in commercial accounts in 7 banks.

A certification was received from the office of the Treasurer of the State of Arizona stating that the certificates of deposit totaling $27,500.00 was on deposit with that office on April 30, 1959.

Verification of the $298,983.30 in commercial accounts was made by reconciling certificates received from the depositories to the Company book balance.

Interest accrued in the amount of $312.50 was computed by the examiner and included as an admitted asset in a foregoing section of this report.

Life insurance premiums uncollected	$12,798.93
Accident and health premiums due and unpaid	$51,165.87

The ceding Company, American Bankers Life Assurance Company of Florida, remits to the Company, on a

monthly basis, premiums actually earned through the month on which the remittance is being made.

Valuations are made on this same basis, for reserve purposes, as will be commented on in a subsequent section of this report.

Verifications of the life insurance premiums uncollected and accident and health premiums due and unpaid was made by reviewing subsequent payments actually received from the American Bankers Life Assurance Company of Florida, and for the purpose of this report, have been accepted by the examiner as an admitted asset.

Interest and other investment income due and accrued	$1,006.23

The interest and other investment income due and accrued at April 30, 1959 consisted of the following:

Interest accrued on bonds	$ 285.41
Interest accrued on savings and loan certificates	408.32
Interest accrued on bank certificates of deposit	312.50
	$1,006.23

Sufficient comment has been made on the above items, under related items to require no further explanation.

LIABILITIES

Aggregate reserve for life policies and contracts	$35,483.38

The Company employs the services of Bowles, Andrews and Towne of Atlanta, Georgia, as consulting actuaries.

To compute the necessary reserves at December 31, 1958, the actuarial firm valued the business in force according to actuarial standards. The American Bankers Life Assurance Company of Florida also computed the reserves by using a factor of 35% of the unearned premiums and arrived at an amount $9,354.00 higher than the amount produced by using actuarial tables. In the annual statement filed by the Company for the year of 1958, the reserve on the basis of the percentage of unearned premiums was established as the liability. For the purpose of this report, this same method has

been used and has been accepted as adequate by the examiner.

Policy and contract claims—life	$1,575.00
Policy and contract claims—accident and health	$13,776.65

The American Bankers Life Assurance Company of Florida, deducts from the premium remittance the claims paid by them.

The actual deductions by the remitting Company was used to arrive at the claim liability outstanding at April 30, 1959.

Commission to agents due or accrued	$18,653.71

Commission to agents due and accrued at April 30, 1959, consisted of the ceding commission of 9½% and writing commissions accrued and unpaid.

This was verified by actually computing the percentages furnished by the Company and reviewing the agreements.

Taxes, licenses and fees due or accrued	$53,678.88

Since the Company receives its business entirely through reinsurance and since all salaries and wages are prorated from an associated Company, there is no actual premium and payroll taxes paid by the Company and the above stated amount is based on the U.S. federal income tax liability for the year of 1958 and through April 30, 1959.

As the new income tax law on insurance Companies has not been finally enacted the Company used a factor of 26% on the net gain from operations for the year 1958 and for the period ended April 30, 1959 and conducted therefrom a payment made in 1959.

These computations were checked by the examiner with no errors being noted and the amount of $53,768.88 has been accepted as sufficient for this liability.

Mandatory security valuation reserve	$39.58

Prior to 1959 the Company did not own any investments that required a reserve. The examiner computed the above reserve to meet the provisions of the Committee on Valuation of the National Association of Insurance Commissioners. A full years reserve was established on the basis of the assets held by the Company at April 30, 1959 without taking into consideration that this report is being submitted on a partial year basis for 1959.

CAPITAL AND SURPLUS

After taking into consideration all known liabilities and contractual obligations the net result of this examination shows the capital and unassigned surplus of the Company, at April 30, 1959, to be as follows:

Capital paid-up	$200,000.00
Unassigned surplus	147,407.42
Total	$347,407.42

CONCLUSION

The courtesy and cooperation of the officers and employees of the Company during the entire course of the examination is hereby acknowledged.

Respectfully submitted

/s/ Guy L. Hammett
Guy L. Hammett
Senior Examiner
Insurance Department of Arizona

[PLAINTIFF'S EXHIBIT 11]

INSURANCE DEPARTMENT OF ARIZONA

PHOENIX, ARIZONA

REPORT OF EXAMINATION OF THE CONSUMER LIFE INSURANCE COMPANY PHOENIX, ARIZONA AS OF DECEMBER 31, 1963

TOM ROBINSON
SENIOR EXAMINER

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Atlanta, Georgia
April 10, 1964

Honorable G. A. Bushnell, Director
Insurance Department of Arizona
718 West Glenrosa
Phoenix, Arizona

Dear Sir:

Pursuant to your instructions and in conformity with the provisions of the Insurance Laws of the State of Arizona, an examination has been made of the books, records, administrative affairs and financial condition of the CONSUMER LIFE INSURANCE COMPANY hereinafter known as such or as the Company, at its Executive Office located in Suite 227 at 919 West Peachtree Street, Atlanta, Georgia. Report of such examination, as of December 31, 1963, is herewith respectfully submitted.

SCOPE OF EXAMINATION

This examination of the Company by a representative of your Department covers the period April 30, 1959, to the close of business on December 31, 1963, with a review of such subsequent transactions as had bearing on the period under review.

The examination embraced a check of recorded transactions, an analysis of certain general ledger accounts, a review of the corporate records, and a verification of assets and establishment of liabilities as of this examination date. Trial balances were independently prepared from Company accounting and other records for the years under examination and the results therefrom were traced into office copies of Annual Statements filed with your Department, with no differences noted.

HISTORY

The Consumer Life Insurance Company was incorporated under the laws of the State of Arizona and received its Certificate of Incorporation from the Arizona Corporation Commission on July 1, 1957.

The Company received its first Certificate of Authority from the Arizona Insurance Department on July 12, 1957, authorizing it to operate as a domestic limited stock life insurance company in the life and disability business with $25,000.00 of capital stock issued.

On March 19, 1959, the Company issued additional capital stock with a par value of $175,000.00, thereby qualifying as a Life and/or Disability Company.

CAPITAL STOCK AND PAID-IN SURPLUS

Article IV of the Company Articles of Incorporation states the authorized capital stock of the corporation shall be one million (1,000,000) shares of common stock of One (1) Dollar par value each.

At December 31, 1963, the total issued and outstanding capital stock of the Company consisted of 200,000 shares of common stock at $1.00 par value each, totaling $200,000.00.

MANAGEMENT AND CONTROL

Stockholders:

The Company is operated strictly on the proprietary plan, each Stockholder being entitled to one vote for each share of stock owned. In accordance with the provisions of the Company's By-Laws the Annual Meeting of the Stockholders, for the election of Directors and the transaction of such other business as may be properly brought before the meeting, is held on the third Tuesday of August of each year at such hour and place as may be stated in the notice of the meeting. Notice of the time and place for the annual meeting of the Stockholders shall be mailed at least ten (10) and not more than fifty (50) days prior thereto.

Special meetings of the Stockholders may be called at any time by the Chairman of the Board, or by the President, or in his absence, by any Vice-President, or by a majority of the Board of Directors. Notice of special meetings shall be mailed not less than five (5)

and not more than fifty (50) days prior thereto, and the business transacted shall be confined to objects stated in the notice and call.

Directors:

The Company's corporate powers and affairs shall be vested in and exercised by a Board of Directors consisting of not less than five (5) nor more than fifteen (15) members.

Directors are elected by the Stockholders at each annual meeting for a term of one (1) year. Vacancies occurring may be filled by the remaining Directors until the next annual meeting of the Stockholders.

Annual meetings of the Board of Directors shall be held on the third Tuesday in August of each year. Regular meetings of the Board of Directors may be held without notice. Special meetings of the Board of Directors may be called by the President or Secretary, or on the written request of two Directors and require written notice to be given to each member at least three (3) days prior thereto. At all meetings of the Board of Directors, annual, regular, or special, a majority of those present, but not less than three (3) members shall constitute a quorum.

Recorded minutes on file indicate the annual meeting of the Board of Directors has been held each year as provided by the Company By-Laws.

As of the date of this examination, the following named persons were members of the Board of Directors:

W. King Grant, Sr.	Wilburn F. Carter, Jr.
Jesse Y. Lynn	W. King Grant, Jr.
J. W. Born	Richard P. Fraser

There is no indication that the Directors receive a fee or compensation in any form for attendance at Board of Directors' meetings.

Officers:

Article VI of the Company By-Laws stipulates the Officers of the Company shall be a President, one or more

Vice-Presidents, as may be determined by the Board of Directors, a Secretary, a Treasurer, and an Assistant Secretary. Any two or more officers may be held by the same person, except the offices of President and Secretary.

All Officers shall perform the duties normally required of their office and such other acts as the Board of Directors may require, with their salaries, if any, fixed by the Board of Directors.

At the date of this examination the duly elected Officers of the Company were as follows:

W. King Grant, Sr.	President
Jesse Y. Lynn	Secretary
Jesse Y. Lynn	Treasurer
Wilbur F. Carter, Jr.	Vice President
W. King Grant, Jr.	Vice President

CORPORATE RECORDS

Articles of Incorporation:

There were no apparent changes of amendments in the Company Articles of Incorporation, during the period under examination.

By-Laws:

There is no indication in the Minute Book that the By-Laws have been amended since their original adoption.

Corporate Minutes:

All corporate minutes are typewritten, properly signed, and maintained in the usual loose-leaf type binder, and appear to accurately reflect the acts and deliberations of the various Corporate Bodies.

FIDELITY BOND

The records made available to the examiner during the course of this examination show the Company to be protected by a Small Loan Companies Bond No. 3614653

jointly with associated companies issued by the Hartford Accident and Indemnity Company, Hartford, Connecticut, providing continuous coverage on all employees in the amount of $100,000.00.

STATUTORY DEPOSITS

At December 31, 1963, the Company had on deposit with the Treasurer of the State of Arizona securities in the par value amount of $107,500.00.

An additional deposit has been made by the Company with the Treasurer of the State of Georgia consisting of securities in the par value amount of $12,000.00.

Both deposits were verified as of December 31, 1963 by direct correspondence with the State Treasurers of Arizona and Georgia.

TERRITORY

The Company is currently authorized to do business in the States of Arizona and Georgia.

PLAN OF OPERATION

The Company is engaged in both the direct writing and reinsuring of Life and Accident and Health coverages on credit insurance risks.

Policies issued by the Company directly as well as those on which reinsurance is assumed may be generally described as follows:

1. Single premium, non-participating, level term Life and Accident and Health policies.
2. Single premium, non-participating, non-cancellable, non-renewable, reducing term Life and Accident and Health policies.

Except in some few instances where the coverage issued is on a reducing term basis, policies are issued for the number of months the borrower elects to amortize the loan, and the face amount of the insurance remains in force during the full term of the loan.

Both policies directly written and reinsured are issued to secure funds advanced by lending institutions with the lender being named first beneficiary and with any residue after the indebtedness has been liquidated reverting to a second beneficiary named by the applicant.

On policies directly written the policyholder has the option of carrying life coverage without having accident and health, or he may carry the latter coverage alone.

Risks assumed by the Company are evidenced by duplicate copies of the original application form bearing the number of the policy issued.

At December 31, 1963, the Company had in force a small amount of non-participating whole life business.

GROWTH OF COMPANY

The growth of the Company is represented in the following exhibit:

Year	Admitted Assets	Capital & Surplus	Premium Income	Insurance In Force
1957	$148,781.61	$124,325.33	$ 69,317.69	$ 1,907,345.00
1958	406,851.89	277,060.92	339,033.75	6,081,859.00
1959	617,504.68	448,133.46	523,548.01	9,069,022.00
1960	708,231.42	552,428.25	619,159.52	12,213,301.00
1961	571,998.94	452,255.45	434,516.23	12,832,814.00
1962	754,132.15	512,862.05	556,401.15	15,623,998.00
1963	931,735.46	630,887.33	529,928.67	14,594,593.00

A further analysis of the growth of the Company, regarding Assets, Liabilities, Capital and Surplus, will be found in a subsequent section of this report captioned, COMPARATIVE FINANCIAL STATEMENT.

MORTALITY EXPERIENCE

The mortality experience of the Company for the period under examination is exhibited on the following page.

CONSUMER LIFE INSURANCE COMPANY
MORTALITY EXPERIENCE

Year	Amount Paid Current Year		(+) Unpaid at Current Year-End		(—) Unpaid at Previous Yr.-End		Incurred Current	
	Life	A & H	Life	A & H	Life	A & H	Life	A & H
1959	$29,427.05	$ 83,571.61	$ 3,537.18	$15,406.52	$ 7,047.00	$15,915.81	$25,917.23	$ 83,062.32
1960	49,021.82	110,225.02	6,275.71	14,749.28	3,537.18	15,406.52	51,760.35	109,567.78
1961	48,856.00	111,746.78	.00	8,274.73	6,275.71	14,749.28	42,580.29	105,272.23
1962	67,997.43	77,232.22	12,551.46	14,396.81	.00	8,274.73	80,548.89	83,354.30
1963	71,268.40	49,232.85	7,250.18	6,586.08	12,551.46	12,124.17	65,967.12	43,694.76

UNDERWRITING PRACTICES

Company procedures in underwriting risks appear standard to industry and have produced favorable results in every year of its operation.

Risks assumed by the Company in its reinsurance operation are underwritten by the direct writing company.

REINSURANCE

Substantial coverage of the Company's credit life and credit accident and health reinsurance operation and comment thereto appear under the captions, PLAN OF OPERATION and UNDERWRITING PRACTICES

The excess over the Company's retention of $10,000.00 on its whole life business is ceded to the Lincoln National Life Insurance Company on an automatic basis.

ACCOUNTS AND RECORDS

The accounts and records of the Company consist of the usual income and disbursement journals, general ledger and subsidiary records.

The books were reviewed for the period under examination, and the accounting has been accepted by the examiner.

FINANCIAL STATEMENTS

Immediately following will be found a statement of the financial condition of the Company at the close of business on December 31, 1963 consisting of Assets, Liabilities, Surplus and Other Funds, as determined by this examination.

Following the Financial Statement will be found supporting Exhibits as detailed below:

Summary of Operations (Accrual Basis)
Surplus Account
Exhibit 2—Net Investment Income (Accrual Basis)
Exhibit 3—Interest Income
Exhibit 5—General Expenses
Exhibit 6—Taxes, Licenses and Fees

Exhibit 12—Reconciliation of Ledger Assets
Reconciliation Between Years

Exhibit 13—Assets

Comparative Financial Statement

Following the Financial Statement and supporting Exhibits, explanatory comments will be found on such statement items as are deemed necessary.

FINANCIAL STATEMENT
DECEMBER 31, 1963

ASSETS

Bonds		$ 91,166.88
Stocks		109,062.00
Savings and Loan Certificates		260,000.00
Collateral Loan		25,000.00
Cash and Bank Deposits		312,395.79
Cash and Invested Assets	$797,624.67	
Life Insurance Premiums Uncollected		41,876.66
Accident and Health Premiums Due and Unpaid		90,068.45
Interest and Other Investment Income Due and Accrued		2,165.68
Total		$931,735.46

LIABILITIES, SURPLUS AND OTHER FUNDS

Aggregate reserve for Life policies and contracts		$130,904.00
Aggregate reserve for Accident and Health policies		65,613.00
Policy and Contract Claims:		
Life		7,250.18
Accident and Health		6,586.08
Premiums and annuity considerations received in advance		125.15
Commissions to agents due or accrued		2,393.70
Taxes, Licenses and Fees due or accrued		6,135.96
Federal income taxes due		43,790.32
Due Parent Company		1,794.34
Mandatory securities valuation reserve		36,255.40
Total Liabilities (Except Capital)		$300,848.13
Capital paid-up	$200,000.00	
Unassigned surplus	430,887.33	
Surplus as regards policyholders		630,887.33
Total		$931,735.46

SUMMARY OF OPERATIONS

(ACCRUAL BASIS)

Premiums and annuity considerations:	
Life	$334,642.43
Accident and Health	276,179.19
Net investment income	28,619.86
Total	$639,441.48
DEDUCT:	
Death benefits	$ 65,967.12
Benefits under Accident and Health policies	44,778.70
Increase in aggregate reserve for policies and contracts	(2,556.90)
Increase in reserve for Accident and Health policies	15,078.62
Commissions on premiums and annuity considerations	287,427.14
General insurance expenses	28,810.84
Insurance taxes, licenses and fees	13,194.95
Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	23,615.89
Total	$476,316.36
Net gain from operations before federal income taxes	163,125.12
Federal income taxes	43,790.32
Net gain from operations (1963)	$119,334.80

SURPLUS ACCOUNT

Unassigned surplus December 31, previous year	$312,862.05	Dividends to stockholders	$ .00
Net gain from operations	119,334.80	Net loss from non-admitted items	1,257.49
Net capital gains	27,903.22	Increase in mandatory securities valuation reserve	27,955.25
		Unassigned surplus December 31 current year	430,887.33
Total	$460,100.07		$460,100.07

EXHIBIT 2—NET INVESTMENT INCOME

(Accrual Basis)

Total interest, dividends and real estate income		$30,243.91
Less:		
Investment expenses	$1,516.36	
Taxes, licenses and fees	107.69	1,624.05
Net Investment income		$28,619.86

EXHIBIT 3—INTEREST INCOME

	Collected 1963	Accrued 1963(+)	Accrued 1962(—)	Earned 1963
Interest on bonds	$ 4,748.72	$ 644.28	$1,350.13	$ 4,042.87
Dividends on stocks	9,854.07	446.40	571.60	9,728.87
Interest on collateral loans	1,625.00	812.50	812.50	1,625.00
Interest on bank deposits	15,072.17	262.50	487.50	14,847.17
Totals	$31,299.96	$2,165.68	$3,221.73	$30,243.91

EXHIBIT 5—GENERAL EXPENSES

	Insurance Life	Insurance A & H	Investment	Total
Rent	$ 361.65	$ 783.58	$ 60.27	$ 1,205.50
Salaries and wages	3,269.58	7,084.09	544.93	10,898.60
Contributions, employees benefit plans	41.79	90.55	6.97	139.31
Legal fees and expenses	253.50	549.25	42.25	845.00
Medical examination fees	31.80	68.90	5.30	106.00
Inspection report fees	53.33	115.54	8.88	177.75
Actuaries fees	220.20	477.10	36.70	734.00
Automobile expense	93.82	203.28	15.64	312.74
Travel expense	419.30	908.49	69.89	1,397.68
Communications	5.12	11.08	.85	17.05
Printing and stationery	489.48	1,060.55	81.58	1,631.61
Depreciation	72.15	156.33	12.03	240.51
Bureau and association dues	106.07	229.81	17.68	353.56
Insurance except real estate	72.85	157.83	12.14	242.82
Sundry expenses	.02	.05	.00	.07
Group service and administrative fees	3,600.00	7,800.00	600.00	12,000.00
Contributions	7.50	16.25	1.25	25.00
General expenses paid (1963)	$9,098.16	$19,712.68	$1,516.36	$30,327.20
General expenses unpaid December 31, 1962, and December 31, 1963	.00	.00	.00	.00
General expenses incurred 1963	$9,098.16	$19,712.68	$1,516.36	$30,327.20

EXHIBIT 6—TAXES, LICENSES AND FEES
(Excluding Federal Income Tax)

	Insurance Life	A & H	Investment	Total
State insurance department licenses and fees	$ 264.25	$ 264.25	$ .00	$ 528.50
U.S. Social Security taxes	100.69	218.17	16.78	335.64
State premium taxes	3,148.20	5,368.23	.00	8,516.43
All other taxes	545.48	1,181.86	90.91	1,818.25
Taxes, licenses and fees paid (1963)	$4,058.62	$7,032.51	$107.69	$11,198.82
Taxes, licenses and fees unpaid, December 31, 1963 (+)	2,219.25	3,916.71	.00	6,135.96
Taxes, licenses and fees unpaid, December 31, 1962 (—)	2,016.07	2,016.07	.00	4,032.14
Taxes, licenses and fees incurred during 1963	$4,261.80	$8,933.15	$107.69	$13,302.64

EXHIBIT 12—RECONCILIATION OF LEDGER ASSETS

INCREASES IN LEDGER ASSETS

Premiums on Life policies and annuity considerations	$300,667.33	
Accident and Health cash premiums	229,261.34	
Interest, dividends and real estate income	31,299.96	$561,228.63

DECREASE IN LEDGER ASSETS

Policy and contract claims:		
Life	$ 71,268.40	
Accident and Health	55,688.11	$126,956.51
Commissions to agents:		
Life	$155,763.97	
Accident and Health	93,471.44	249,235.41
General Expenses	30,327.20	
Taxes, licenses and fees	11,198.82	
Federal income taxes	17,047.52	
Decrease in ledger liabilities	111.19	
From sale or maturity of ledger assets	2,423.61	$437,300.26

RECONCILIATION BETWEEN YEARS

Increase in ledger assets during year	$123,928.37
Amount of ledger assets, end previous year	640,015.23
Total Ledger Assets, December 31, 1963	$763,943.60

EXHIBIT 13—ASSETS

	Ledger Assets	Non-Ledger Assets	Assets Not Admitted	Net Admitted Assets
Bonds	$ 91,166.88	$	$	$ 91,166.88
Stocks	72,594.18			72,594.18
Stocks (Market over book value)		36,467.82		36,467.82
Savings and loan certificates	260,000.00			260,000.00
Cash and bank deposits	312,395.79			312,395.79
Collateral loans	25,000.00			25,000.00
Deferred and uncollected premiums (Life)		41,876.66		41,876.66
Due and unpaid premiums (Accident and Health)		90,068.45		90,068.45
Interest due and accrued		1,719.28		1,719.28
Dividends due		446.40		446.40
Furniture and equipment	2,786.75		2,786.75	
Totals	$763,943.60	$170,578.61	$2,786.75	$931,735.46

COMPARATIVE FINANCIAL STATEMENT

ASSETS

	Dec. 31, 1963	April 30, 1959	Increase in Period
Bonds	$ 91,166.88	$ 29,160.29	$ 62,006.59
Stocks	72,594.18		72,594.18
Market over book value of stocks	36,467.82		36,467.82
Savings and loan certificates	260,000.00	50,000.00	210,000.00
Collateral loans	25,000.00		25,000.00
Cash and bank deposits	312,395.79	326,483.30	(14,087.51)
Deferred and uncollected premiums	41,876.66	12,798.93	29,077.73
Due and unpaid premiums (Accident & Health)	90,068.45	51,165.87	38,902.58
Interest due and accrued	1,719.28	1,006.23	713.05
Dividends due	446.40		446.40
Totals	$931,735.46	$470,614.62	$461,120.84

LIABILITIES, SURPLUS AND OTHER FUNDS

Aggregate reserve for Life policies and contracts	$130,904.00	$ 35,483.38	$ 95,420.62
Aggregate reserve for accident and health policies	65,613.00	.00	65,613.00
Policy and contract claims:			
Life	7,250.18	1,575.00	5,675.18
Accident and Health	6,586.08	13,776.65	(7,190.57)
Premiums and annuity considerations received in advance	125.15	.00	125.15
Commissions to agents due and accrued	2,393.70	18,653.71	(16,260.01)
Taxes, licenses and fees due or accrued	6,135.96	33,678.88	(27,542.92)
Federal income taxes due	43,790.32	20,000.00	23,790.32
Due parent company	1,794.34		1,794.34
Mandatory securities valuation reserve	36,255.40	39.58	36,215.82
Total liabilities (except capital)	$300,848.13	$123,207.20	$177,640.93
Capital paid-up	200,000.00	200,000.00	.00
Unassigned surplus	430,887.33	147,407.42	283,479.91
Totals	$931,735.46	$470,614.62	$461,120.84

COMMENTS ON FINANCIAL STATEMENT

ASSETS

Bonds **$91,166.88**

The investment or amortized value of company owned bonds at December 31, 1963, amounted to $91,166.88 and consisted of the following:

Description	Book and Amortized or Investment Value
Georgia State School Building Authority	$ 9,413.73
Georgia State School Building Authority	10,957.19
Total States	$20,370.92
City of Phoenix, Arizona	$ 9,731.24
City of Redondo Beach, California	10,000.00
City of Atlanta, Georgia (Airport bonds)	5,248.00
City of Atlanta, Georgia (Airport bonds)	10,491.69
City of Monticello, Georgia (Gas)	13,591.68
City of Moultrie, Georgia (W & S)	5,130.52
Cherokee County, Georgia (W)	5,175.96
Total Political Subdivisions	$59,369.09
Phillips Petroleum	$11,426.87
Total Industrial	$11,426.87
Total Bonds	$91,166.88

One bond issue, Georgia State School Building Authority, Series 1954—2.8%, due 3/1/72 having a par value of $12,000.00 is on deposit with the Treasurer of the State of Georgia at this examination date. Verification of this deposit was made during the course of this examination.

Other bonds owned were verified by physical count and inspection in the presence of company officials at the Company's depositories.

All bonds owned by the Company are eligible investments as defined in Chapter 3, Article 2 of the Arizona Insurance Code—1963.

The following is a reconciliation of the bond portfolio from April 30, 1959, the date of last examination to and including December 31, 1963.

Book value of bonds at April 30, 1959		$ 29,160.29
Cost of bonds acquired:		
5/1/59 to 12/31/59	$100,326.95	
1960	72,997.64	
1961	13,000.00	
1962	56,791.59	
1963	345,070.00	588,186.18
Increase by adjustment in book value—all years	$ 1,384.31	1,384.31
Profit on sale of bonds—all years	$ 1,700.67	1,700.67
Total Increases		$620,431.45
Deduct:		
Consideration for bonds sold:		
5/1/59 to 12/31/59	$ .00	
1960	70,901.90	
1961	30,670.00	
1962	101,500.00	
1963	325,250.00	$528,321.90
Decrease by adjustment in book value—all years	$ 861.21	861.21
Loss on sale of bonds—all years	$ 81.46	81.46
Book value of bonds at December 31, 1963		$ 91,166.88

Interest accrued in the amount of $644.28 and interest earned in the amount of $4,042.87 on bonds in 1963 are included in Exhibit 2 of this report.

Stocks **$109,062.00**

At December 31, 1963, the Company owned stocks having a market value amounting to $109,062.00. The stocks are classed as follows:

Description	Cost	Book Value	Market Value
Banks and insurance companies	$56,393.25	$56,393.25	$ 91,949.50
Industrial and common	16,200.93	16,200.93	17,112.50
	$72,594.18	$72,594.18	$109,062.00

Dividends received on these stocks during 1963 amounted to $9,854.07.

Verification of these stocks was made by physical count and inspection in the Company's depository. The market value was established from financial publications and reputable dealer quotations. The increase of the market over the book value amounting to $36,467.82 is shown as an admitted asset in the financial section of this report.

Savings and Loan Certificates $260,000.00

At December 31, 1963, the Company owned savings and loan certificates issued by twenty-six (26) federally insured savings and loan associations.

Of the total amount of $260,000.00, eight certificates aggregating $80,000.00 were on deposit with the Treasurer of the State of Arizona at December 31, 1963. Verification of these certificates, comprising a portion of the total deposit with the Treasurer of the State of Arizona was made by direct mail.

The remaining eighteen certificates aggregating $180,000.00 were verified by physical count and inspection.

Cash and Bank Deposits $312,395.79

At December 31, 1963, the Company had certificates of time deposits in three Arizona banks totaling $27,500.00, all being a part of the statutory deposit made by the Company with the Treasurer of the State of Arizona. These deposits were verified by direct correspondence with that department during the course of the examination.

Verification of the remaining $284,895.79 in commercial accounts was made by reconciling certificates received from the depositories to the company book balance.

Interest accrued in the amount of $262.50 on these accounts is included in the admitted assets section of the foregoing financial report.

Collateral Loan $25,000.00

At December 31, 1963, the Company's investment portfolio contained one collateral loan in the amount of $25,000.00. The collateral consisted of a one quarter (¼) undivided interest in three tracts of unimproved land containing 185.8 acres all in the "Land Lot 370 of the 18th District of DeKalb County, Georgia". The file contained a promissory note, a deed to secure debt, (both of which were executed by DeJongh Franklin, an individual), an appraisal and a title insurance policy. The note specifies 6½% interest semi-annually and has a maturity date, January 10, 1965. The deed to secure debt had been recorded in the records of the DeKalb County Clerk.

The remaining three quarters (¾) undivided interest is owned by interests identified with the parent company, the Southern Discount Company, and was so held previous to May 9, 1962, the date of the collateral loan.

Life Insurance Premiums Uncollected $41,876.66

Accident and Health Premiums Due and Unpaid $90,068.45

Verification of life insurance premiums uncollected was made at the same time the reserve on life policies were valued. Accident and health premiums due and unpaid were verified by reviewing subsequent payments received by the Company.

Interest and Other Investment Income Due and Accrued $2,165.68

At December 31, 1963, interest and other investment income due and accrued consisted of the following:

Interest on bonds	$ 644.28
Dividends on stocks	446.40
Interest on collateral loans	812.50
Interest on bank deposits	262.50
Total	$2,165.68

Other comment deemed sufficient has been made under related asset accounts and require no further explanation.

Furniture and Equipment **$2,786.75**

At December 31, 1963, the Company's investment in furniture and equipment amounted to $2,786.75. This amount has been shown as an asset not admitted in the financial section of this report.

LIABILITIES

Aggregate Reserve for Life Policies and Contracts **$130,904.00**

At December 31, 1963, a valuation of the aggregate reserves for life policies and contracts produced the following:

	Amount	Reserve
Life Insurance:		
1941 CSO 3% CRVM	$ 992,531.00	$ 15,302.00
130% 1941 CSO 3% NL	10,500.00	52.00
Unearned premium—credit	10,830,780.00	104,691.00
Unearned premium—credit group	2,750,782.00	10,618.00
Total	$14,584,593.00	$130,663.00
Less reinsurance		492.00
Total Life Insurance		$130,171.00
Accidental Death:		
1926-33 Inter Co. of 1941 CSO 2½%		$ 441.00
Less reinsurance		37.00
Total Accidental Death		$ 404.00
Disability—Active Lives:		
1926 Class 3 Disability with 1941 CSO 2½%		$ 344.00
Less reinsurance		15.00
Total Disability—Active Lives		$ 329.00
Grand Total—Aggregate reserve for Life policies and contracts		$130,904.00

A close review of the valuation of these reserves was made by your examiner during the course of this examination and found the original valuation to be without substantial error and the reserves so established adequate.

At the same time the detailed review was made of the reserve valuation at December 31, 1963, the deferred and uncollected premiums were established and have been commented on in the asset section of this report.

Aggregate Reserve for Accident and Health Policies **$65,613.00**

At December 31, 1963, the aggregate reserve for accident and health polices was computed to be $65,613.00.

A close review of the method used to arrive at this amount and a review of the amount arrived at showed the reserve to be adequate.

Policy and Contract Claims—Life **$7,250.18**

Policy and Contract Claims—Accident and Health **$6,586.08**

At December 31, 1963, policy and contract claims—Life amounted to $7,250.18 and policy and contract claims—Accident and Health, $6,586.08.

Verification of these amounts was made by reviewing disbursements subsequent to the examination date.

Premiums and Annuity Considerations **$125.15**

At December 31, 1963 premiums and annuity considerations were found to be $125.15.

Commissions to Agents Due or Accrued **$2,393.70**

At December 31, 1963 commissions to agents, due or accrued amounted to $2,393.70 and were as follows:

Life	$1,436.22
Accident and Health	957.48
	$2,393.70

Federal Income Taxes Due or Accrued	$48,790.32

Federal income taxes due or accrued were established to be $43,790.32 at December 31, 1963. This amount was verified by an inspection of the return and payment made subsequent to the date of examination.

Due Parent Company	$1,794.34

As a result of services rendered and expense incurred, the amount of $1,794.34 was due the parent company at December 31, 1963.

Mandatory Security Valuation Reserve	$36,255.40

At December 31, 1963, the Company established the amount of $36,255.40 to meet the provisions of the Committee on Valuation of the National Association of Insurance Commissioners.

This reserve was reviewed by the examiner and found to be adequate.

CAPITAL AND SURPLUS

After taking into consideration all known liabilities and contractual obligations the net result of this examination shows the capital and unassigned surplus of the Company, at December 31, 1963, to be as follows:

Capital Paid-up	$200,000.00
Unassigned Surplus	430,887.33
	$630,887.33

CONCLUSION

The courtesy and cooperation of the officers and employees of the Company during the course of this examination is hereby acknowledged.

Respectfully submitted,

/s/ Tom Robinson
Tom Robinson
Senior Examiner
Insurance Department of Arizona

[PLAINTIFF'S EXHIBIT 18]

REPORT ON EXAMINATION

OF THE

AMERICAN BANKERS LIFE ASSURANCE

COMPANY OF FLORIDA

MIAMI, FLORIDA

AS OF

DECEMBER 31, 1960

PARTICIPATION

STATES	ZONES	REPRESENTATIVES
NORTH CAROLINA	2	JAMES W. THOMAS
FLORIDA	3	WILLIAM W. DOWNS
GEORGIA	3	PHILIP S. MUMFORD
TEXAS	5	DOYLE SEWELL

Hon. Frank Sullivan, Chairman
Committee on Examinations and
Chairman, Zone 5, N. A. I. C.
Topeka, Kansas

Hon. Otis M. Whitney
Chairman, Zone 1, N. A. I. C.
Boston, Massachusetts

Hon. Walter D. Davis
Chairman, Zone 3, N. A. I. C.
Jackson, Mississippi

Hon. Charles F. Gold
Chairman, Zone 2, N. A. I. C.
Raleigh, North Carolina

Hon. William E. Timmons
Chairman, Zone 4, N. A. I. C.
Des Moines, Iowa

Hon. J. Edwin Larson
Insurance Commissioner
State of Florida
Tallahassee, Florida

Hon. Paul A. Hammel
Chairman, Zone 6, N. A. I. C.
Carson City, Nevada

Sirs:

In accordance with your instructions, and pursuant to the provisions of the Insurance Laws of the State of Florida, a Convention Examination has been made as of December 31, 1960 of the financial condition and affairs of the

AMERICAN BANKERS LIFE ASSURANCE
COMPANY OF FLORIDA
600 BRICKELL AVENUE
MIAMI 32, FLORIDA

hereinafter generally referred to as the Company, and a report thereon is submitted respectfully as follows:

SCOPE OF EXAMINATION

The last previous examination was made as of December 31, 1957 by representatives of the Insurance Departments of the States of Florida, Ohio and Tennessee. The examination reported herein was made by representatives of the Insurance Departments of the States of Florida, North Carolina, Texas and Georgia, the latter state having been invited as an intra-zone representative of Zone 3.

[2] This examination was commenced on October 9, 1961 and ended December 1, 1961. It covered the period from January 1, 1958 to the close of business December 31, 1960. The financial statement included in this report is based upon the records of the Company with a verification of assets and a determination or estimation of liabilities. When found necessary, transactions subsequent to the date of examination also were reviewed. Comments are made on these and other matters under appropriate headings, in conformance with generally accepted examination procedures.

A concurrent examination was made as of December 31, 1960 of the American Bankers Insurance Company, an affiliated company, which owned 144,000 shares, a 24.65% interest of the life company.

* * * *
[13] * * * *

Credit Life and Accident and Health

The Company had in force fourteen reinsurance agreements with domestic companies providing from 70% to 100% cessions of certain credit life and credit A&H business. On 100% cessions, the Company received commissions varying from 10% to 67½%, contingent upon the services rendered.

[14] Nine companies not having sufficient capital or surplus, or a combination of both, to meet the statutory requirements for companies admitted to do business in the State of Florida were ruled as unauthorized reinsurers by the Insurance Commissioner. Such reinsurance premium reserves, and balances recoverable from accounts and claims due from these companies were, therefore, not admitted. The unauthorized companies are indicated by an asterisk * in the following listing of all domestic reinsurers:

** Beehive Insurance Company
Phoenix, Arizona

** Colorado Life Insurance Company
Phoenix, Arizona

Consumers Life Insurance Company
Phoenix, Arizona

* Delta Life Insurance Company
Phoenix, Arizona

* Deseret Life Insurance Company
Phoenix, Arizona

Florida-Georgia International Life
Insurance Company
Atlanta, Georgia

* Life Protection Insurance Company
Dallas, Texas

Main Life Insurance Company
Phoenix, Arizona

** National Life Insurance Company
Phoenix, Arizona

* Protective Life Insurance Company
Jefferson City, Missouri

Tennessee Credit Life Insurance Company
Memphis, Tennessee

* Universal General Life Insurance Company
Houston, Texas

* American Universal Life Insurance Company
Clayton, Missouri

* * * *
* * * *

[46]

Aggregate Reserve for Accident & Health Policies	**$2,032,378.00**

The above consists of the following items:

Credit Accident and Health (Individual)	**$1,859,679.00**
Less Reinsurance	**242,280.00**
Credit A&H (Net)	**$1,617,399.00**
Group Credit A&H	**$ 362,040.00**
Less Reinsurance	**32,452.00**
	$ 329,588.00
Present Value—Claims not yet due	**$ 85,391.00**
Total A&H Reserve	**$2,032,378.00**

The mathematics and procedures were checked from premium-in-force tabulations and found to be correct. The Company computes its Credit A&H reserves on the "sum of the digits" method which meets the minimum requirements of Florida. The "sum of the digits" method is accepted as the minimum reserve for this business.

The Reinsurance credit includes $194,363.00 ($161,911 Individual Credit A&H, $32,452 Group Credit A&H), for business ceded to reinsurers in foreign countries which has been shifted to the liability item "Amounts Withheld by Company . . ." will be commented upon in that section of the report.

The present value of claims not yet due is a manual inventory of future installment payments on insured loans which have become claims. The amount is accepted.

* * * *

[58] CONCLUSION

This examination has determined that as of December 31, 1960, the Company was possessed of admitted assets of $10,582,311.78 and liabilities, excluding capital of $8,853,093.33. Paid up capital of $585,000.00 and Unassigned Surplus of $1,144,218.45 provided additional protection to policyholders in the amount of $1,729,218.45.

In addition to the undersigned, the services of Mr. John S. Ripandelli, Consulting Actuary of the Florida

Insurance Department, are hereby recognized in preparation of the policy reserve valuations and certain related phases, for this report.

The courteous cooperation of the Officers and employees of the Company during the examination is hereby acknowledged.

Respectfully submitted,

/s/ William W. Downs
William W. Downs, Examiner
State of Florida

/s/ Philip S. Mumford
Philip S. Mumford, Examiner
State of Georgia

/s/ James H. Thomas
James H. Thomas, Examiner
State of North Carolina

/s/ Doyle Sewell
Doyle Sewell, Examiner
State of Texas

[PLAINTIFF'S EXHIBIT 19]

REPORT ON EXAMINATION

OF THE

AMERICAN BANKERS LIFE ASSURANCE

COMPANY OF FLORIDA

MIAMI, FLORIDA

AS OF

DECEMBER 13, 1963

PARTICIPATION

STATES	ZONES	REPRESENTATIVES
ARIZONA	6	THOMAS L. ROBINSON
ARKANSAS	5	LESLIE T. MYERS
GEORGIA	3	B. FOLGER WEST
FLORIDA	3	MELVIN COURSIN

Miami, Florida
June 15, 1964

Honorable J. Edwin Larson
Chairman, Committee on Examinations,
Chairman, Zone 3, N.A.I.C.
Tallahassee, Florida

Honorable Harvey G. Combs
Chairman, Zone 5, N.A.I.C.
Little Rock, Arkansas

Honorable Paul A. Hammel
Chairman, Zone 6, N.A.I.C.
Carson City, Nevada

Sirs:

In accordance with your several instructions, and pursuant to the provisions of the Insurance Laws of the State of Florida, an Association Examination has been made as of December 31, 1963, of the financial condition and business affairs of the

AMERICAN BANKERS LIFE ASSURANCE
COMPANY OF FLORIDA
MIAMI, FLORIDA

hereinafter generally referred to as the Company, at its home office located at 600 Brickell Avenue.

A report thereon is respectfully submitted as follows:

[2] INTRODUCTION

The last previous examination was made as of December 31, 1960, by representatives of the Insurance Departments of the States of Florida, Georgia, North Carolina, and Texas.

The examination herein reported was conducted by representatives of the Insurance Departments of Arizona, Arkansas, Georgia, and Florida.

This examination commenced on April 13, 1964, and covered the period from January 1, 1961, through the close of business December 31, 1963.

SCOPE OF EXAMINATION

This examination was conducted in accordance with procedures established for the conduct of Association examinations by the National Association of Insurance Commissioners.

Assets were verified and liabilities determined by physical inspection, certifications, test checks, and detailed reviews to the extent deemed necessary.

* * * *
* * * *

[18]

Credit Life and Accident and Health

The Company has in force 19 reinsurance agreements with eleven domestic companies in which it assumes, cedes and retroceeds life and accident and health business. These companies are:

Name of Company	State of Domicile
American Universal Life Insurance Company	Missouri
*Bay Life Insurance Company	Texas
*Colorado Life Insurance Company	Arizona
Consumer Life Insurance Company	Arizona
*Delta Life Insurance Company	Arizona
Diamond State Life Insurance Company	Delaware
First Security Life Insurance Company	Texas
Florida-Georgia International Life Insurance Company	Florida
[19] Main Life Insurance Company	Arizona
Merit Life Insurance Company	Indiana
Tennessee Credit Life Insurance Company	Tennessee

The above three listed companies indicated by an asterisk(*) were not possessed of sufficient capital or surplus, or a combination of both, to meet the requirements of the State of Florida for authorized reinsurers. Amounts due and recoverable from those reinsurers were

not reported by the Company as assets or as offsets against liabilities in its annual statements. Such amounts are treated in the same manner for the purposes of this examination.

At the time of the last previous examination there were reinsurance agreements in force with certain alien reinsurance companies as discussed in the report of that examination. At December 31, 1963, all contracts with those companies had been cancelled and there remained reinsurance in force under only one contract. By mutual consent the reinsurance in force on that one contract was reassumed by the Company early in 1964. At the date of this report there was no reinsurance in force with alien companies.

* * * *

[59] * * * *

Aggregate Reserve for Accident & Health Policies	$3,762,024.00

The above reserve consisted of unearned premiums on individual credit A&H and dismemberment; group credit A&H and dismemberment; individual ordinary A&H and, the present value of payments of claims not yet due (continuing claims). The breakdown follows:

	Unearned Premium Reserve	Continuing Claims
Individual ordinary A&H	$ 772.00	$ 721.00
Individual credit A&H—direct	1,908,159.00	137,572.00
Individual credit A&H—assumed	368,200.00	——
Individual credit dismemberment	20,671.00	——
Group credit A&H	1,396,582.00	64,090.00
Group credit dismemberment	24,313.00	——
Total (gross) A&H	$3,718,697.00	$ 202,383.00
Reinsurance		
Individual credit A&H	$ 116,834.00	$ 12,386.00
Group credit A&H	23,955.00	5,881.00
Total reinsurance	140,789.00	18,267.00
Total (net) A&H	$3,577,908.00	184,116.00
		3,577,908.00
Grand total A&H		$3,762,024.00

Ordinary unearned premiums were a straight line pro-rata of the model premiums, and was accepted. The present value of ordinary claims not yet due was the present value of the disabled lives annuity—1926 Class (3) Disability Tables and 3%. These amounts are actuarially correct and were accepted.

[60] The credit life unearned premiums, both individual and group, A&H and dismemberment, were obtained by applying the "sum of the digits" method to the original gross premium. This method is acceptable under the Florida statute for decreasing single premium credit life A&H insurance both individual and group. The program used in the electronic data processing equipment was reviewed and sufficient checks of the results satisfied the examiner as to their accuracy.

The continuing claims were established by manual listing of all outstanding claim files at the end of the year. To the total amount of monthly payments still potentially payable to the expiration date of the policy

certain factors were applied to obtain the claim reserve. These factors were:

Months Remaining in Policy	Claim Reserve Factor
1	100%
2	75
3	70
4	65
5	60
6	55
7-20	50
21 & over	35

These factors have been used for a number of years, and apparently are "judgment" factors. It is recommended that during the period between examinations comparative statistics be maintained on each claim which will test actual claims paid to the reserve established at December 31, 1963. The results of this comparative study should be furnished to the examiners at the next examination in order to test the adequacy of the factors used.

Reinsurance credit for continuing claims was taken only for authorized foreign companies in the amount shown. The amount for unauthorized reinsurance, $33,-390.74, was not included in the reinsurance credit.

* * * *

[68] CONCLUSION

This examination has determined that at December 31, 1963, the Company was possessed of net admitted assets of $19,265,065.71. Liabilities, excluding capital, amounted to $17,056,610.82, which, with capital paid-up of $747,695.00, resulted in unassigned surplus of $1,-460,759.89.

John S. Ripandelli, consulting actuary for the Insurance Department of Florida, reviewed policy reserve valuations and other related assets and liabilities shown in this report.

The assistance and cooperation extended the examiners by Company personnel during this examination is hereby acknowledged.

Respectfully submitted,

/s/ Melvin Courson
Melvin Courson, Examiner
State of Florida

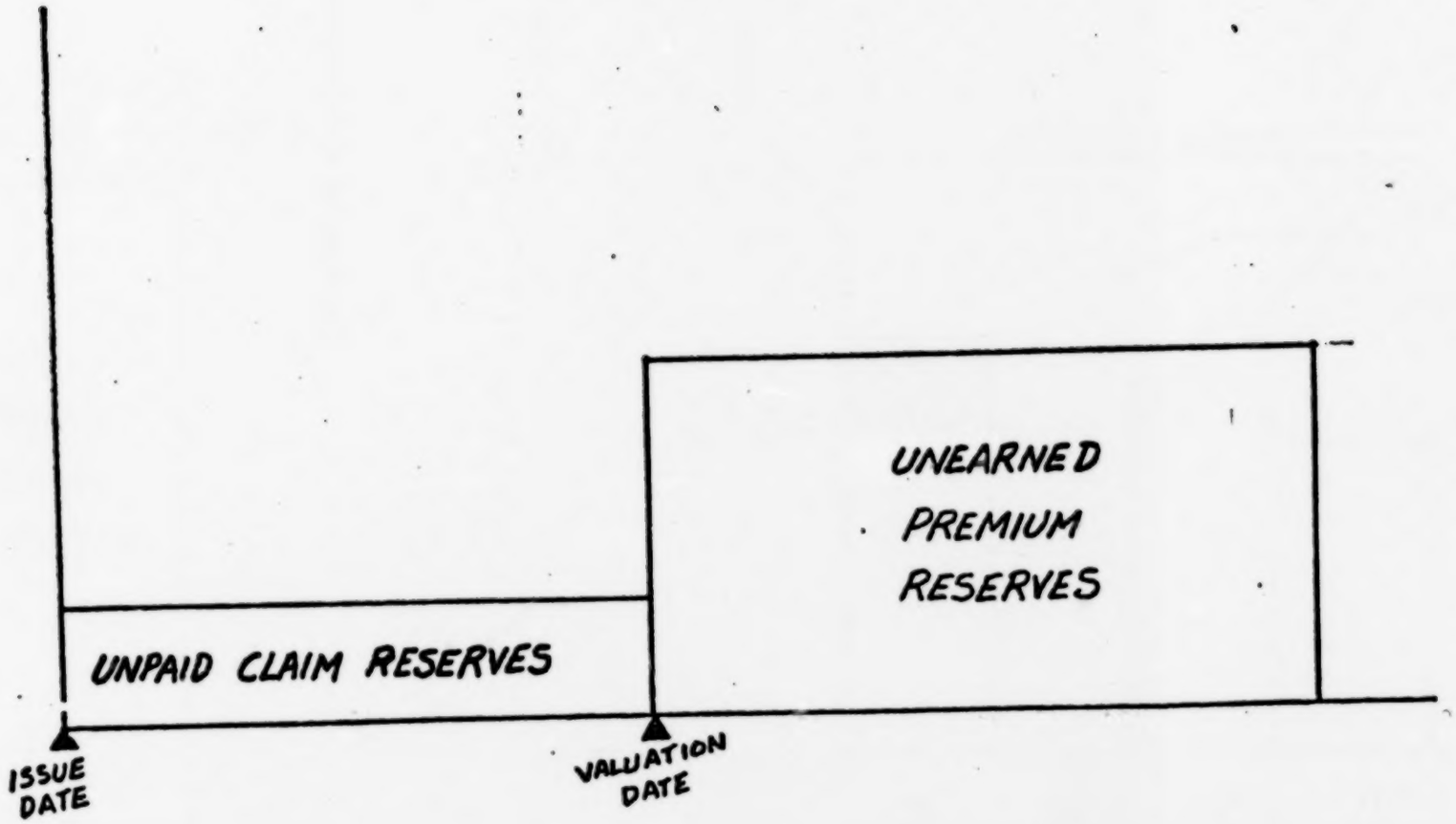
/s/ B. Folger West
B. Folger West, Examiner
State of Georgia
Representing Zone 3, N.A.I.C.

/s/ Leslie T. Myers
Leslie T. Myers, Examiner
State of Arkansas
Representing Zone 5, N.A.I.C.

/s/ Thomas L. Robinson
Thomas L. Robinson, Examiner
State of Arizona
Representing Zone 6, N.A.I.C.

I

RESERVES

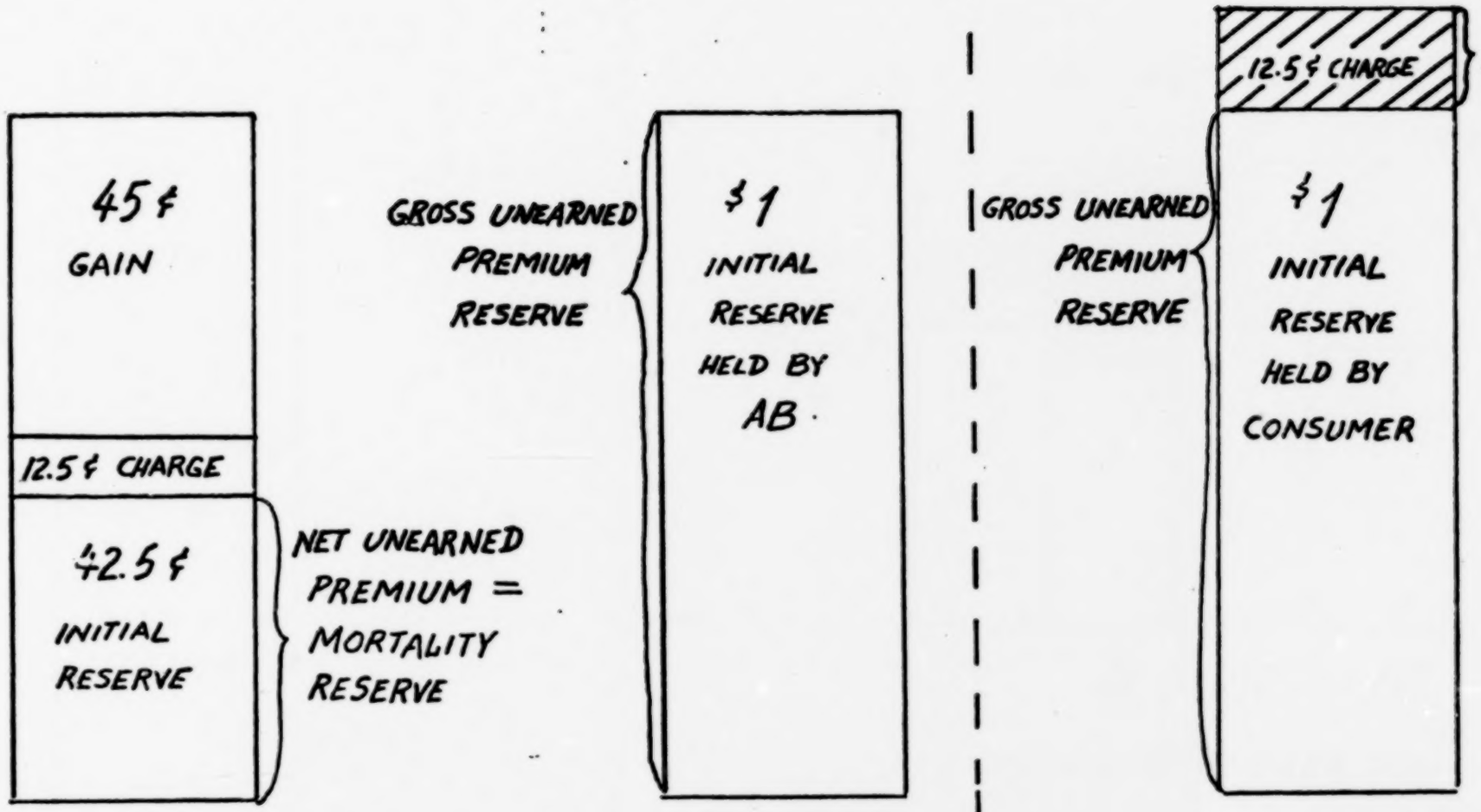


: HELD FOR CLAIMS
ALREADY INCURRED
BUT STILL UNPAID

: HELD FOR CLAIMS
YET TO BE INCURRED

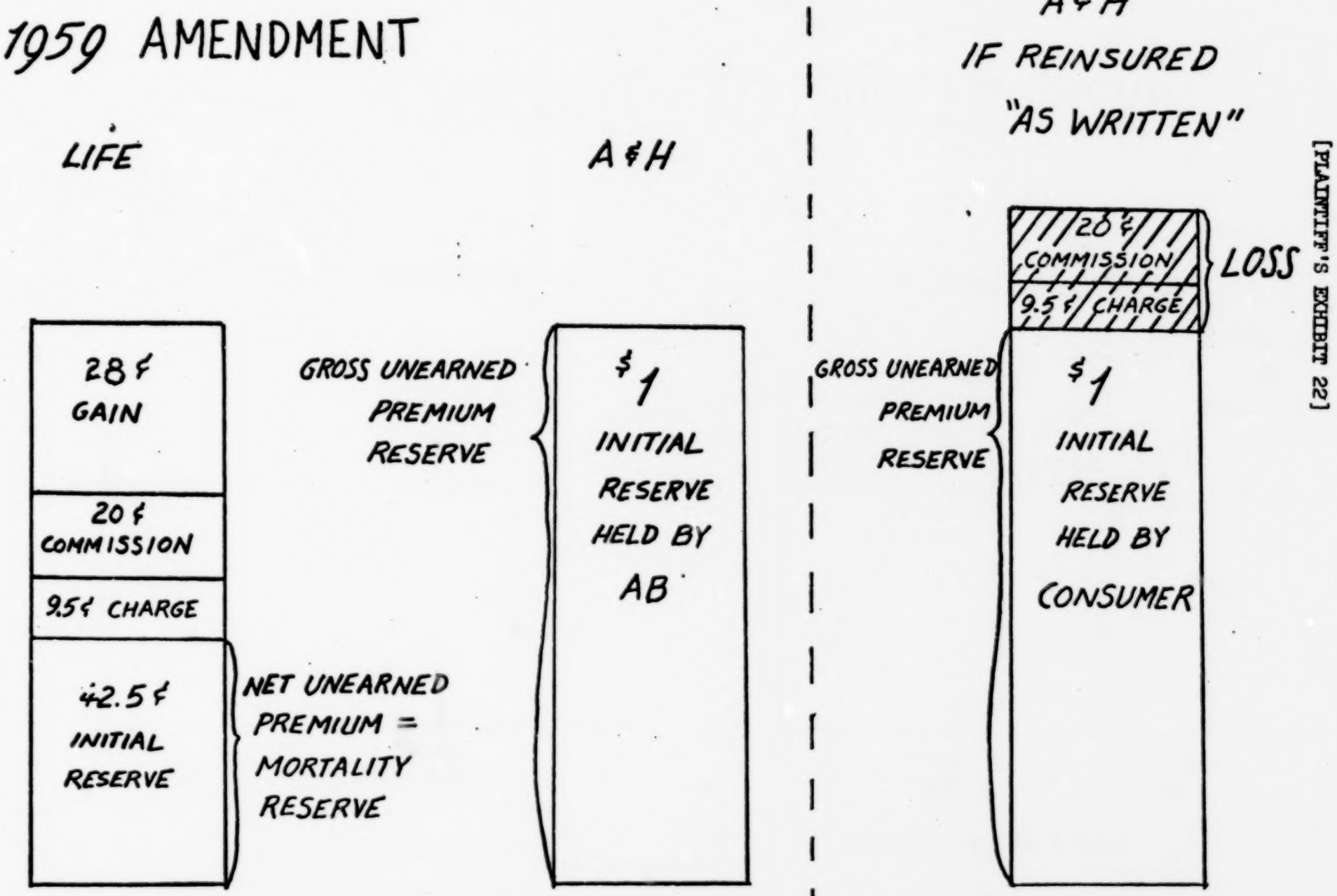
[PLAINTIFF'S EXHIBIT 20]

1957 AGREEMENT



[PLAINTIFF'S EXHIBIT 21]

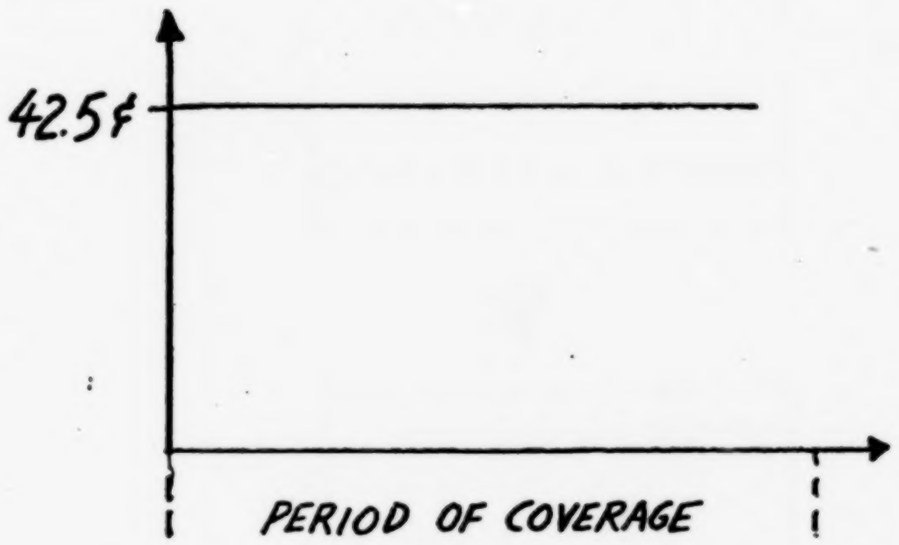
1959 AMENDMENT



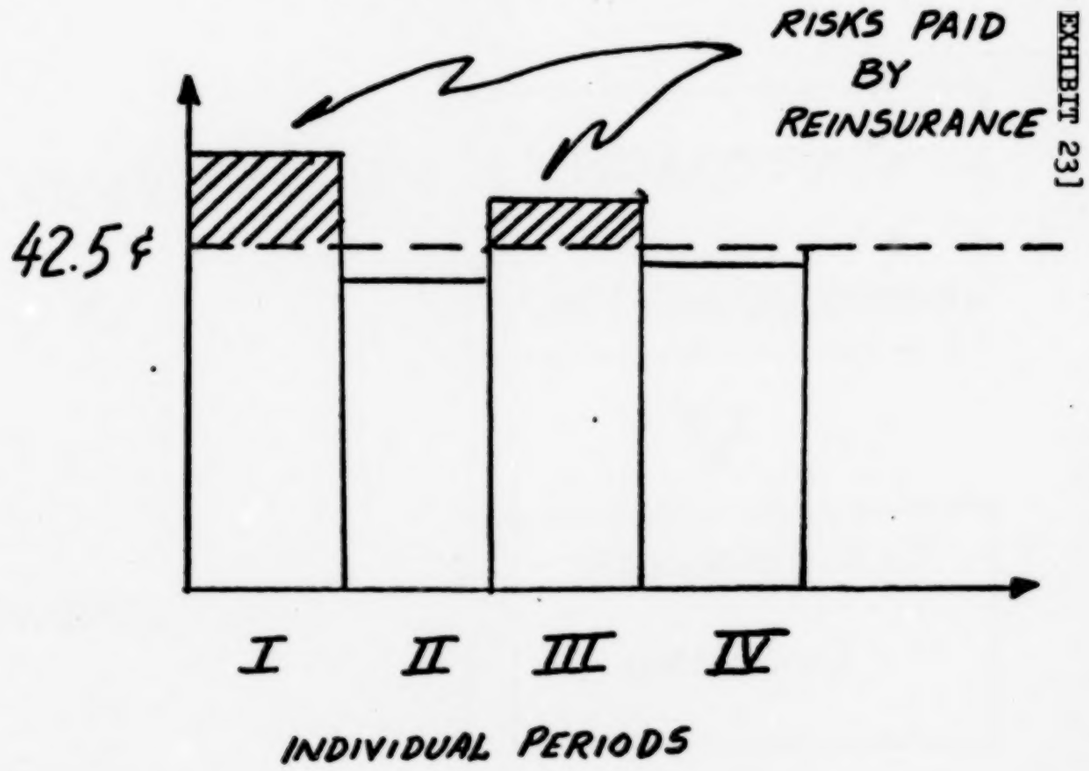
[PLAINTIFF'S EXHIBIT 22]

REINSURANCE TO SPREAD RISKS

ANTICIPATED MORTALITY



ACTUAL MORTALITY



[PLAINTIFF'S EXHIBIT 23]

INITIAL EFFECT OF 1957 AGREEMENT

LIFE		A & H
RESERVES = 0 RETENTION = 12.5 ¢ GAIN = 12.5 ¢ LESS EXPENSE	AMERICAN BANKERS	RESERVES = $1 LOSS = INITIAL EXPENSE
▼		▽
RESERVES = 42.5 ¢ GAIN = 45 ¢	CONSUMER LIFE	RESERVES = 0 GAIN = 0

[PLAINTIFF'S EXHIBIT 24]

INITIAL EFFECT OF 1962 AGREEMENT

LIFE		A&H
RESERVES = 42.5¢ COMMISSIONS = 50¢ GAIN = 7.5¢	CONSUMER LIFE	RESERVES = 20¢ COMMISSIONS = 10¢ LOSS = 10¢
	▼	
	AMERICAN BANKERS	RESERVES = 80¢ COMMISSIONS = 40¢ LOSS = 40¢

[PLAINTIFF'S EXHIBIT 25]

CONSUMER LIFE
RATIO OF PREMIUMS WRITTEN TO SURPLUS

$$\text{RATIO} = \frac{\text{PREMIUMS WRITTEN}}{\text{SURPLUS}}$$

ASSUME EXISTING SURPLUS OF $1 AND NEW PREMIUMS WRITTEN IN AMOUNTS OF $1 EACH LIFE AND A $H:

WITHOUT 1962 AGREEMENT

$$\text{RATIO} = \frac{\$2}{\$1 + 7.5¢ - 50¢} = \frac{\$2}{57.5¢}$$

or ≈ 3½ to 1

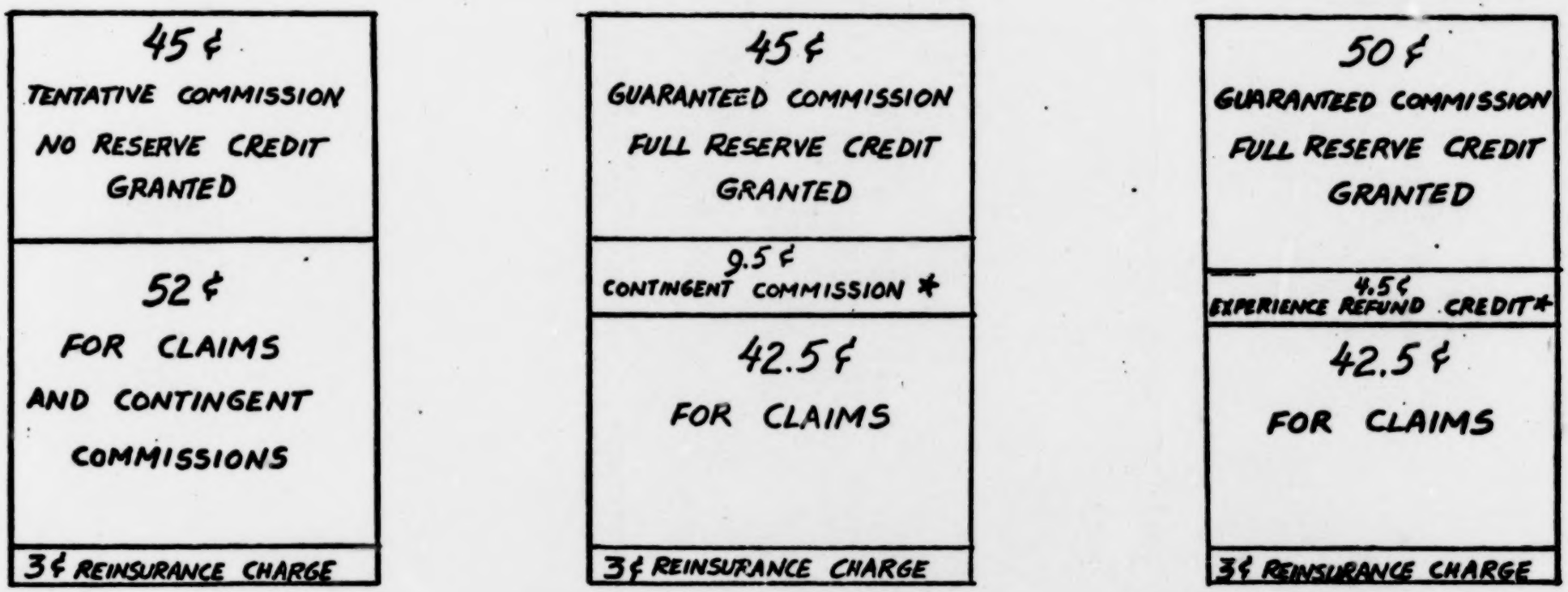
WITH 1962 AGREEMENT

$$\text{RATIO} = \frac{\$2 - 80¢}{\$1 + 7.5¢ - 10¢} = \frac{\$1.20}{97.5¢}$$

or ≈ 1¼ to 1

[PLAINTIFF'S EXHIBIT 26]

COMPARISON OF AGREEMENT TYPES



* NO RESERVE CREDIT GRANTED UNTIL EARNED

[PLAINTIFF'S EXHIBIT 27]

SUPREME COURT OF THE UNITED STATES

No. 75-1221

UNITED STATES, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

ORDER ALLOWING CERTIORARL. Filed May 24, 1976

The petition herein for a writ of certiorari to the United States Court of Claims is granted. The case is consolidated with Nos. 75-1260 and 75-1285 and a total of one and one-half hours is allotted for oral argument.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1976 215115 276

Supreme Court, U. S.
FILED
APR 12 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1975

No. 75-1221

UNITED STATES OF AMERICA,

Petitioner,

vs.

CONSUMER LIFE INSURANCE COMPANY,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

E. MICHAEL MASINTER
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Counsel for Respondent

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

NO. 75-1221

UNITED STATES OF AMERICA,

Petitioner,

v.

CONSUMER LIFE INSURANCE COMPANY,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

QUESTION PRESENTED

The question presented is whether the United States may disqualify Respondent as a "life insurance company" for Federal income tax purposes by attributing to Respondent unearned premium reserves on accident and health insurance policies, under circumstances in which such reserves were held by another insurance company unrelated to Respondent, subject to the terms of valid, customary reinsurance agreements, and were not included in Respondent's reserves pursuant to applicable state law.

STATEMENT OF THE CASE

Respondent generally accepts the statement of the facts as set forth in the Petition. However, Respondent differs with Petitioner in certain respects. Petitioner incorrectly states that Respondent "freely conceded . . . that it assumed the entire insurance risk under Treaty I on all credit life and credit accident and health policies . . . ." Petition at 7. Respondent has never formally made such a concession; rather, this statement seems to have been taken from a colloquy between the Trial Judge and counsel for Respondent at the Hearing on the Facts, concerning the operative features of the complex reinsurance transaction in issue. Transcript at 179-180, 182. Respondent does not make such a concession.

Second, the Petitioner refers to the Trial Judge's finding of fact that the Respondent's likelihood of loss pursuant to the subject reinsurance treaty was so remote as to be negligible. Petition at 9, n. 2. The Trial Judge did make such a finding, but the Respondent contended below that such a finding was not supported by the evidence and the Court of Claims made no such similar finding in its ultimate findings of fact.

Finally, certain of Petitioner's allegations concerning state law are based on issues such as the credibility of certain of Petitioner's witnesses, whereas in fact the Court of Claims, after reviewing the transcript of relevant testimony, was able to make no findings of fact which would support Petitioner's allegations.[1]

REASONS FOR DENYING THE WRIT

As the basis for its Petition, the Government asserts

[1] *See also* note 2 *infra*.

that a conflict exists as a result of the decisions of the Court below and certain Courts of Appeals which have considered cases similar to the instant case, and Petitioner urges the adoption of a uniform national rule. Respondent respectfully disagrees that any conflict exists, and furthermore, due to the very nature of the issues, respectfully submits that the review of this case would not result in the formulation of a uniform national rule.

There is a very clear factual distinction between the instant case and the case of *Economy Finance Corp. v. United States*, 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U. S. 947 (1975), a decision which Petitioner asserts is in conflict with the decision below. In *Economy*, the Court of Appeals was faced with a situation in which the stockholders of Economy (a consumer finance company) formed a family insurance agency which acted as agent for all of the insurance sold through the finance company. While the accident and health reserves were held by an unrelated insurance company pursuant to reinsurance agreements, the facts disclosed that, by agreement, these funds were reinvested in interest-bearing debentures of Economy, and the interest earned on these debentures was paid to the family-owned insurance agency as additional commissions. The Seventh Circuit emphasized the fact that the unrelated insurance company did not retain the reserves, and did not even retain the right to the return on the investment, due to the fact that the funds were returned to the finance company in the form of loans and the interest earned on the loans was paid to the family insurance agency. Thus the facts in *Economy* are significantly different from the instant facts and the basis for the decision in *Economy* could well be founded upon a

lack of economic substance whereas such facts are not present in the instant case. This distinction was pointed out by the Court of Claims in the case of *Penn Security Life Insurance Co. v. United States*, 524 F.2d 1155, 1162 (Ct.Cl. 1975), where the court stated that such circumstances "could well be understood as making that ceding company the agent of those taxpayers." Indeed, there is no indication that the Court of Claims would not have reached a similar conclusion had it been faced with similar facts. It is submitted that *Economy* does not present the conflict which Petitioner asserts.

The case of *First Railroad & Banking Co. v. United States*, 514 F.2d 675 (5th Cir. 1975) is also distinguishable on its facts; the insurer *and* the reinsurer in *First Railroad* were both wholly-owned by the parent lending institution, resulting in similarities to *Economy* and to the case of *Superior Life Insurance Co. v. United States*, 462 F.2d 945 (4th Cir. 1972).

The factual situations in *Economy, supra,* and *First Railroad, supra,* are clearly distinguishable from the present case and those cases do not present a conflict with the present case. Although the reinsurance treaties in both cases bear some similarities to the treaties entered into by Respondent, the relationships between the contracting parties in those cases could not be ignored by the courts. There were no such relationships between Respondent and the other insurance company. It would be futile to attempt to establish a uniform rule for application to clearly distinguishable facts.

Respondent respectfully submits that the resolution of the issue presented by this case and the other cases which are now being considered by this Court on Petitions for Writ of Certiorari are not susceptible to the adoption of a uniform rule. Each of these cases clearly demonstrates that the factual issues, the ownership structure, and the terms of the reinsurance treaties between the various companies all differ in substantial and material respects. The decisions of the courts below demonstrate that the results of these cases turn on the factual issues; thus, these cases are not appropriate for the application of a uniform rule of law, particularly in view of the lack of any precise definition contained in the statute itself. Furthermore, each insurance company is subject to different laws and regulations regarding insurance companies in the various states in which they have their principal offices or conduct their businesses, and the expressed intent of Congress in considering the *Life Insurance Company Income Tax Act of 1959* was *not* to impose a system of Federal regulation on insurance companies, but rather to base the scheme of taxation on the existing state regulatory practices. *See, e.g.*, Statements of Rep. Curtis, *Hearings on Life Insurance Company Tax Act before a Subcommittee of the House Comm. on Ways and Means*, 85th Cong. 2d Sess. 176 (1959).

In the instant case, the basis for the decision below concerning the issue of whether the reserves were required by law as prescribed by §801(c)(3) of the Internal Revenue Code of 1954 was the interpretation of applicable state law.[3] The court below rejected the Government's contention to the effect that state law was

[3] The Petitioner argues that Georgia and Arizona law did not require Respondent to establish a reserve for the accident and health policies at issue and states that the Court of Claims did not appear to refute the Trial Judge's analysis of the applicable state statutes. Petition at 21, n. 7. This statement is incorrect in

not consistent with Respondent's treatment of the reserves and stated that, with regard to doubtful or ambiguous statutes,

> ". . . it is generally accepted that in the absence of a court decision, the interpretation placed thereon by the regulatory body charged with enforcement thereof is compelling authority. Federal courts have applied this rule to state administrative interpretations or actions under state statutes." 524 F.2d 1167, 1176 (1975).

The court cited many authorities which clearly indicate that the principle of law quoted above is well established. Furthermore, *Economy* and *First Railroad* did not deal with this issue and, therefore, the conflict argued by the Petitioner does not exist as to this issue.

The Petitioner also argues that there are presently pending administratively 90 cases concerning this issue, involving more than $28 million of taxes, and that this issue has a great impact on the revenue. These are assumptions which cannot be substantiated by information available to Respondent. It should be noted, however, that this amount of taxes, even if correct, does not

---

that these issues were argued by Respondent on brief at great length; see, for example, Plaintiff's Reply Brief at 22-24, 25, and 28-30 (May 17, 1975), wherein Respondent went to great length to point out that the testimony of the Petitioner's witnesses was not entitled to any weight. The court below obviously agreed with Respondent's contentions in stating:

> "Finally, with relation to the testimony of Mr. Sturtevant, who testified that the unearned premium reserve as reported by American Bankers and plaintiff were permitted 'unwittingly' by the Georgia insurance authorities, we have reviewed his testimony and it does not change our interpretation of the Georgia law above expressed." 524 F.2d 1167, 1178 (1975).

represent revenue lost but, by reason of the application of laws relating to the taxation of life insurance companies, represents principally tax *deferred* revenues.

The Petition for Writ of Certiorari in this case represents but another attack by the Internal Revenue Service upon the companies in the credit insurance industry, an attack which, for the most part, has not proved fruitful from the Government's point of view unless other non-insurance related issues have been present. The only cases in which the Government has succeeded have been those in which the facts clearly demonstrated common control of all of the parties, *e.g.*, *Superior*, *supra*, and *First Railroad*, *supra*, or control of the funds under question, *e.g.*, *Economy Finance*, *supra*. In other situations, such as *Commissioner v. First Security Bank*, 405 U. S. 394 (1972), *Alinco Life Insurance Company v. United States*, 373 F.2d 336 (Ct.Cl. 1967), *Penn Security*, and the instant case, the various legal theories asserted by the Government have not met with acceptance by the courts. In *First Security Bank* the Government relied on Section 482, and in *Alinco* the Government relied on Section 269, as well as the general theories of tax law; and finally in this case and in the *Penn Security* case, the Government relies on its theory of "reserves follow the risk." In addition to the Governments' position in all of these cases, the Treasury Department also attempted to persuade Congress that companies offering credit life and credit accident and health insurance, referred to by the Treasury Department as "specialty business," should be taxed differently from other companies, but Congress chose not to follow the recommendation of the Treasury Department. *See* Testimony of Hon. Fred C. Scribner, Jr., and Hon. Dan Throop

Smith, *Hearings on Life Insurance Company Tax Act before a Subcommittee of the House Comm. on Ways and Means*, 85th Cong. 2d Sess. 41 et seq. (1958). A review of the instant case by this Court would not serve the cause of justice in this area of the law. To the contrary, due to the many factual intricacies and variances between the state laws involved, such a review could possibly result in additional cases being litigated. It would seem that the Government's plea for uniformity could well be settled by its adoption of a position consistent with the cases already decided.

CONCLUSION

For the reasons stated, it is respectfully submitted that the instant case is not an appropriate one for review by this Court and the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

E. MICHAEL MASINTER

JAMES H. LANDON
HANSELL, POST,
BRANDON & DORSEY
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Atlanta, Georgia 30303
(404) 581-8000

April 9, 1976

Supreme Court, U. S.
FILED
AUG 4 1976
MICHAEL RODAK, JR., CLERK

Nos. 75-1221, 75-1260 and 75-1285

In the Supreme Court of the United States

OCTOBER TERM, 1976

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES CAURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

ROBERT H. BORK,
Solicitor General,
SCOTT P. CRAMPTON,
Assistant Attorney General,
STUART A. SMITH,
Assistant to the Solicitor General,
ERNEST J. BROWN,
GARY R. ALLEN,
HERBERT GROSSMAN,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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216-901—76——1

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In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

No. 75-1285

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

No. 75–1221. The recommended decision of the trial judge (Pet. App. A 1a–66a) is not reported. The findings of fact and opinion of the Court of Claims (Pet. App. B 67a–129a) are reported at 524 F. 2d 1167.

No. 75–1260. The memorandum opinion of the district court (Pet. App. B 8a–18a) is not reported. The opinion of the court of appeals (Pet. App. A 1a–7a) is reported at 514 F. 2d 675.

No. 75–1285. The opinion of the Court of Claims (Pet. App. 1a–60a), incorporating the opinion of the trial judge with minor changes and some additions, is reported at 524 F. 2d 1155.

JURISDICTION

No. 75–1221. The judgment of the Court of Claims was entered on October 22, 1975 (Pet. App. B 67a, 129a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The petition was filed on February 25, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

No. 75–1260. The judgment of the court of appeals was entered on June 11, 1975 (Pet App. A 1a–7a), and a petition for rehearing was denied on October 8, 1975 (Pet. 2). By order dated December 12, 1975, Mr. Justice Powell extended the time for filing a

[1] The amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (Pet. App. B 129a).

petition for a writ of certiorari to and including March 6, 1976. The petition was filed on March 5, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

No. 75–1285. The judgment of the Court of Claims was entered on October 22, 1975 (Pet. App. 1a, 60a).[2] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The petition was filed on March 9, 1976, and was granted on May 24, 1976. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined in Section 801(c).

The question presented is whether an insurance company, which bears the ultimate insurance risk on accident and health policies transferred under reinsurance arrangements with other companies, is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life policies so as to disqualify it from the preferential tax treatment accorded to a life insurance company; or whether such non-life reserves should be attributed to the other com-

[2] The amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims (Pet. App. 60a).

panies that temporarily hold the single payment premiums on the policies and later pay them (less claims paid) over to the company bearing the insurance risk, retaining only a commission for their administrative services.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

(a) Life Insurance Company Defined.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) Life Insurance Reserves Defined.—

(1) In general.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or mor-

bitity tables and assumed rates of interest, and

(B) which aer set aside to mature or liquidate, either by payment or reinsurance, future unaccrused claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) Total Reserves Defined.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.801-3 Definitions.

* * * * *

(e) Unearned premiums.—The term "unearned premiums" means those amounts which

shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801–5 Total reserves.

* * * * *

(b) Reserves required by law defined.—For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policy holders or beneficiaries.

* * * * *

STATEMENT

I. No. 75–1221

A. Respondent Consumer Life Insurance Company is a wholly-owned subsidiary of Southern Discount Company. At the time of respondent's incorporation in 1957 under the Insurance Code of Arizona and thereafter, its parent, Southern Discount, was engaged in the consumer finance business in Georgia and several other states. When Southern Discount made a loan, its borrowers usually purchased term life and term accident and health ("A&H") insurance in order to provide for the payment of the loan in the event of the borrower's death or disability (Pet. App. B 68a–69a, 94a–95a).

This type of insurance, known as credit life and credit A&H insurance, is generally coextensive in term and coverage with the term and amount of the loan, and provides for the full payment of the loan balance in the event of the borrower's death or for the payment of monthly installments on the loan in the event of his disability resulting from accident or sickness. The premiums for such insurance are generally payable by the borrower as a single premium for the full period of coverage (Pet. App. B 68a–69a, 94a–95a).

The Georgia law under which Southern Discount was incorporated prohibited it from issuing credit life and credit A&H insurance itself. However, it was permitted to act as a sales agent for qualified insurance companies issuing such policies. Prior to its formation of respondent, Southern Discount acted as a sales agent for American Bankers Life Assurance Company, a Florida corporation which issued credit life and credit A&H policies to Southern Discount's debtors. Under its arrangement with American Bankers, Southern Discount received a commission of approximately 50 percent of the premiums paid by the

policyholders, which was the maximum commission rate allowed by law (Pet. App. B 69a).

1. TREATY I

In order to obtain a greater portion of the profits from the credit insurance issued to its borrowers, Southern Discount organized respondent in 1957 for the purpose of underwriting the credit life and credit A&H insurance for its borrowers. Under Georgia law, respondent's initial $38,000 capitalization was insufficient to enable it to act as a direct insurer. However, because of its status as an insurance company chartered in Arizona, respondent was permitted to reinsure risks under policies issued by other companies authorized to issue insurance directly. As a result, on June 28, 1957, respondent entered a reinsurance agreement or treaty ("Treaty I") with American Bankers under which it reinsured the risks under all credit life and credit A&H policies thereafter issued by American Bankers to individuals obtaining loans from Southern Discount and its subsidiaries (Pet. App. B 69a–70a, 95a–99a).

The Treaty I contract specifically provided that respondent agreed to reimburse American Bankers "for all losses actually paid on [both] Life policies and * * * Health and Accident policies * * *" (Pet. App. B 114a). Respondent therefore freely conceded in the court below (A. 130–133) that under the Treaty I arrangement, it assumed the entire insurance risk on both the credit life and the credit A&H policies. In exchange for assumption of the risks under these

policies, respondent received 87½ percent (subsequently increased to 90½ percent) of the premiums collected by American Bankers (Pet. App. B 70a–71a, 113a–114a).

Pursuant to Treaty I, American Bankers collected the premiums in full when it issued the policies, and paid all claims under the policies. Each month American Bankers remitted to respondent its full share of all life insurance premiums received by it during the previous month. However, with respect to the credit A&H premiums, American Bankers remitted to respondent each month only the "earned premiums," *i.e.*, that portion of the premiums collected during the prior month that was ratably allocable to the A&H coverage for the prior month.[3] The remaining portion of respondent's share of A&H premiums was remitted monthly on a pro rata basis over the balance of the period of coverage. Thus, while respondent received its share of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired (Pet. App. B 70a—71a, 110a–117a).

The agreement further provided that respondent would maintain reserves with respect to the credit life insurance and that American Bankers would

[3] The trial judge noted (Pet. App. B 102a–103a) that the established method in the insurance industry for computing accident and health insurance reserves is on the basis of the portion of premiums that remains "unearned" on the reserve valuation date. The "unearned premium reserve" is equal to the portion of the premiums which is attributable to periods of future coverage.

maintain reserves for "unearned premiums on the A&H insurances." Finally, the agreement could be terminated by either party on 30 days notice. However, in the event of termination, the agreement provided that it was to "continue to apply to all policies reinsured hereunder before such termination becomes effective" (Pet. App. B 70a–71a, 110a–117a).

2. TREATY II

By 1962, respondent's capital had increased sufficiently to enable it to qualify as a direct insurer under Georgia and North Carolina law. As a result of this change in respondent's status, on April 18, 1962, American Bankers and respondent entered into a second reinsurance agreement ("Treaty II") under which their roles were purportedly reversed. Pursuant to Treaty II, respondent became the primary insurer of the credit life and A&H policies issued to Southern Discount's borrowers. American Bankers agreed to reinsure 80 percent of the liability under each A&H policy (but none of the life insurance) issued by respondent (Pet. App. B 72a–73a, 99a).

Treaty II provided that respondent was to remit quarterly to American Bankers the premiums collected on the ceded 80 percent share of the A&H insurance less its own tentative commission of 50 percent. The agreement further provided that American Bankers would subsequently return to respondent a quarterly rebate or "experience refund" equal to the total premiums ratably allocable to the insurance coverage for the prior quarter, less the sum of: (1) the

50 percent tentative commission previously retained by respondent with respect to such "earned" premiums, (2) three percent of gross earned premiums allocable to such quarter, and (3) the sum of all claims paid during the quarter by American Bankers on such policies. If the sum of these three reductions exceeded the premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against the experience refund for that quarter (Pet. App. B 72a–74a, 120a–121a).

As of December 31, 1964, Treaty II was amended to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, if it was not absorbed by that time. The effect of this amendment was that American Bankers would in all events receive its 3 percent commission on premiums on the ceded A&H coverage, and would incur no loss unless it experienced average claims on these policies exceeding 47 percent (50 minus 3) of premiums over a period of more than five consecutive years. Conversely, there were no circumstances under which American Bankers' profit under Treaty II could have exceeded its three percent commission (Pet. App. A 46a–48a, Pet. App. B 72a–74a, 128a).

The loss experience on A&H insurance under Treaty I had ranged from 28 to 30 percent of premiums paid. At the time of the 1964 amendment, the loss experience on A&H insurance covered by Treaty II during the three years it had been in force was only 18 percent of premiums paid. Thus, the

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trial judge found that the likelihood that loss experience would run so high as to jeopardize American Bankers' commission was so remote as to be negligible, and that the parties knew this to be the fact (Pet. App. A 47a—48a; Pet. App. B 74a).

B. During 1958–1964, respondent reported on the annual statements it was required to file with the Arizona and Georgia insurance authorities that it received income equal to the full amount of life insurance premiums and it reported the life insurance reserves for such policies prescribed under the appropriate actuarial tables. However, with respect to the A&H insurance respondent reinsured with American Bankers under Treaty I, respondent reported as income only the portion of premiums paid to it by American Bankers, which was attributable to the expired portions of the terms of the policies (Pet. App. B 71a–72a).

Respondent did not report, either as income or as an asset, any of the A&H premiums attributable to the unexpired portions of the terms of those non-life policies, and it reported no reserves whatsoever with respect to the A&H policies. Similarly, respondent reported no reserves on the 80 percent portion of the A&H insurance that was ceded to American Bankers under Treaty II. American Bankers, on the other hand, maintained unearned premium reserves with respect to both the A&H insurance reinsured by respondent under Treaty I and the A&H insurance ceded to it by respondent under Treaty II (A. 226; Pet. App. B 72a).

Respondent was subjected to a number of examinations during 1958–1964 by the insurance departments of Arizona, Georgia and other states in which it did business. No state regulatory authority took exception to its failure to maintain reserves with respect to the A&H coverage under Treaty I and II (Pet. App. B 71a–72a, 74a–76a, 101a–102a, 105a–107a). However, the Senior Actuary and Chief Examiner of the Georgia Insurance Department testified that respondent's failure to report in its annual statement the unearned premium A&H reserves under both Treaties was permitted "unwittingly" by the Georgia authorities (A. 239) and was in fact contrary to that state's policy (A. 211–213, 215, 221–226, 232–233, 240, 241–242, 256–259). In his view, Treaty II was not a valid reinsurance agreement because respondent did not transfer any risk (A. 225).[4] Similarly, the Arizona examiner who had conducted respondent's triennial examination for that state for 1963 testified that respondent should have been required to maintain the unearned premium A&H reserves under Treaty II, but had been permitted to exclude them from its reserves because it was the first time that the Arizona

[4] The Georgia official stated that under Treaty I respondent should have been required to establish an asset for "premium[s] in the course of collection" and a corresponding liability for unearned premium reserves for the A&H coverage issued directly by it. He further testified that under Treaty II respondent should not have been permitted to eliminate from its annual statement the unearned premium reserves for the portion of the A&H coverage ceded to American Bankers because respondent had not transferred any risk to American Bankers (A. 169, 211–212, 215, 222–223, 232, 239, 240, 241–242, 256–259).

authorities had encountered such an arrangement (A. 266–268).

Respondent prepared its federal income tax returns for the years 1958–1964 in accordance with its methods of reporting reserves on its annual statements filed with the various state insurance authorities. For each of the years in question (1958–1964), respondent took the position on its tax returns that it qualified for the preferential tax treatment accorded to a "life insurance company" as defined by Section 801(a) of the Internal Revenue Code because its reported life insurance reserves exceeded 50 percent of its total reserves as reported on its annual statements (Pet. App. B 76a–77a).

On audit, the Commissioner of Internal Revenue determined that the unearned premium reserves on the A&H insurance under both Treaty I and II should have been included in respondent's total reserves. When the A&H reserves were taken into account, respondent failed to qualify as a "life insurance company" under the Section 801(a) definition for its taxable years 1958–1960, 1962–1964, because its non-life insurance reserves exceeded 50 percent of its total reserves. The Commissioner thereupon recomputed respondent's tax liability and determined deficiencies on the ground that respondent was an ordinary insurance company taxable under Sections 831 and 832 of the Code and not taxable as a life insurance company as defined by Section 802 of the Code (Pet. App B 92a–94a).

C. Respondent brought this refund suit for $351,393.88 in the Court of Claims (A.6). In its claim for refund, respondent had conceded that one of the reasons for entering into the reinsurance agreement was "to minimize its tax liability" (A. 27). At the trial, the president of Southern Discount acknowledged to the trial judge "that assumption of the risk is the basic hallmark" of both insurance and reinsurance (A. 40). He also conceded that under Treaty I, Consumer Life assumed as reinsurer the same degree of risk under the ceded A&H insurance as it did with respect to the credit life insurance (A. 47–48), and that under both treaties, Consumer Life was obliged to bear all losses because they were paid out of the premiums that would otherwise have been earned by it (A. 51–57).

The trial judge's recommended decision upheld the Commissioner's determination that respondent was required to treat the reserves attributable to the A&H insurance as part of its total reserves and, therefore, that it did not qualify as a "life insurance company" under Section 801(a) of the Code. The trial judge premised his conclusion on the ground that, with respect to both Treaty I and II, respondent was required under Georgia and Arizona law to maintain the reserves attributable to the A&H insurance so that such reserves were includable in respondent's total reserves as "other insurance reserves required by law" under Section 801(c)(3) of the Code. As a result, the trial judge found it unnecessary to reach

the government's further contention that respondent was required to include in its total reserves the A&H reserves as "unearned premiums" under Section 801 (c)(2) of the Code (Pet. App. A 14a–23a).

With one judge dissenting, the Court of Claims disagreed with the recommended decision of the trial judge. In accordance with its decision on the same day in *Penn Security Life Insurance Co.* v. *United States* (No. 75–1285), the court held that the A&H reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because American Bankers was in physical possession of the unearned portion of the premiums paid in advance on the A&H coverage in question under both Treaty I and Treaty II (Pet. App. B 81a). In rejecting the trial judge's conclusion that respondent was required by Georgia and Arizona law to include the A&H reserves in its total reserves, the majority relied upon the fact that respondent's method of reporting its income and reserves did not result in the institution of any action by the Georgia and Arizona insurance authorities (Pet. App. B 81a–92a).

The dissenting judge adhered to the views expressed in his dissent in *Penn Security* that the A&H reserves should be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because "[respondent] has arranged to have [such reserves] ostensibly carried for it by others, though in reality it bears the risk of loss itself" (524 F. 2d at 1167). In so concluding, the dissenting judge agreed with *Economy Finance Corp.* v. *United States,*

501 F. 2d 466, (C.A. 7), certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending , No. 74–701, which held, on facts essentially identical to those of Treaty I, that the company's failure to include in "total reserves" the reserves for A&H policies on which it bore the actual insurance risk "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (524 F. 2d at 1167) (Pet. App. B 92a).

II. No. 75–1260

A. Petitioner First Railroad & Banking Company of Georgia was the common parent of a group of affiliated corporations, for which it filed consolidated federal income tax returns for the years 1961 through 1964. During that period, petitioner excluded from these consolidated returns the income of a second-tier subsidiary, First of Georgia Life Insurance Company, on the ground that Georgia Life qualified as a "life insurance company" under Section 801(a) of the Code and therefore could be excluded from the "affiliated group" for consolidated return purposes pursuant to Section 1504(b)(2) (Pet. App. B 8a–9a).

Georgia Life was primarily engaged in issuing credit life and credit accident and health (A&H) insurance to borrowers from credit companies. Such insurance was generally coextensive in term and coverage with the term and amount of the underlying indebtedness, and provide a means for satisfying the indebtedness in the event of the debtor's death or disa-

bility resulting from sickness or accident (Pet App. B. 11a).

Upon the issuance of the insurance, Georgia Life was required by state law to establish reserves on its books reflecting its liability to the policyholders. In the case of A&H coverage, the reserve was computed on the basis of "unearned premiums," *i.e.*, the amount of the premium attributable to periods of future coverage. Thus, in the first instance, the reserve was equal to the total premiums paid in advance (Pet. App. B 12a).

In order to reduce its A&H reserves, Georgia Life entered into a reinsurance agreement with its parent, First of Georgia Insurance Company (Georgia Insurance), on December 31, 1961 (Pltf. Ex. 12, A. 185–194). That agreement provided that 60 percent of the coverage on the A&H insurance issued by Georgia Life and 60 percent of the A&H premiums paid thereon would be ceded to Georgia Insurance.[5] The agreement further provided that Georgia Life was entitled to a maximum commission of 96 percent of the premiums earned on reinsured business, reduced dollar for dollar by the amount of claims paid (Pet. App. A 4a; Pet. App. B 12a–13a).

Thus, Georgia Life bore the entire ultimate insurance risk on the reinsured policies in an amount up to its 96 percent commission. Georgia Insurance's share of the premiums on the ceded coverage was limited to

[5] The agreement was later amended to provide that 70 percent of each A&H policy and the premiums paid would be ceded to Georgia Insurance (Pet. App. B 12a).

four percent of the premiums. Like the Treaty II arrangement in No. 75–1221, if the claims on the reinsurance in any particular period exceeded Georgia Life's 96 percent share of ceded premiums, Georgia Insurance was entitled to carry such excess forward against Georgia Life's commission for subsequent periods. However, during the period in question, the actual claims on the reinsured policies averaged only 22 percent of total premiums received (Pet. App. A 4a; Pet. App. B 13a–14a, A. 98).

Pursuant to the reinsurance agreement, Georgia Insurance accrued 60 percent of the premiums paid on the credit A&H insurance issued by Georgia Life, and reflected an unearned premiums reserve liability on its own books with respect to the A&H premiums. Georgia Life, in turn, took a 60 percent deduction from the unearned premiums reserves reflected on its own books for the A&H insurance. As in No. 75–1221, the Georgia Insurance officials did not challenge this treatment of reserves under the reinsurance agreement after their periodic examinations of Georgia Life's books (Pet. App. B 12a, 16a).

For federal tax purposes, petitioner took the position that its second-tier subsidiary Georgia Life was a "life insurance company" within the meaning of Section 801(a) of the Code. In its view, the reduction of part of Georgia Life's A&H reserves with respect to the A&H insurance ceded to Georgia Insurance enabled Georgia Life to meet the 50 percent test of Section 801(a) (A. 29–30; Pltf. Ex. 10, A. 183–184). Accordingly, petitioner excluded Georgia Life

from the group of its affiliated corporations that filed consolidated returns, and Georgia Life filed separate returns claiming the preferential tax treatment of a life insurance company (Pet. App. A 8a–9a).

B. On audit, the Commissioner of Internal Revenue determined that Georgia Life's "total reserves" should have included reserves for the A&H coverage purportedly ceded to Georgia Insurance and that it therefore failed to qualify as a "life insurance company" for any of the years in question. The Commissioner accordingly assessed deficiencies against petitioner, the parent of Georgia Life (Pet. App. A 9a). Petitioner paid the additional taxes and thereafter commenced this refund suit in the United States District Court for the District of Georgia (A. 3–23).

At the trial, the presidents of Georgia Insurance and Georgia Life acknowledged that tax considerations played a role in the decision to enter into the reinsurance arrangement (A. 66, 94). Because the profit of Georgia Life was reduced dollar for dollar by the loss experience up to 96 percent of the premiums, petitioner's expert witness conceded that the reinsurance arrangement did not transfer the risk of loss to Georgia Insurance (A. 122–123).

Professor Robert Zelten of the University of Pennsylvania Wharton School of Business, a qualified insurance expert by virtue of his teaching position in the Insurance Department of that school, testified that Georgia Life had improperly reduced its A&H reserves with respect to policies ceded to Georgia Insurance. He stated that "* * * the reinsurance agree-

ment entered into between Georgia * * * Life and Georgia Insurance * * * [was not really] a bona fide reinsurance agreement" (A. 155). Professor Zelten based his opinion "on the fact that the ceding commission * * * paid to Georgia * * * Life, would move dollar for dollar with losses incurred on the business reinsured, up to loss ratios of 96%, and therefore all of the loss experience directly impacted on Georgia * * * Life and not on Georgia Insurance" (A. 156). The contingency that the losses might exceed 96% did not affect Professor Zelten's opinion "because * * * the 96% potential breaking point in this case was really a remote possibility" (A. 156). Zelten was of the opinion that Georgia Life obtained no advantage from the arrangement other than a tax benefit (A. 178).

Professor Zelten's opinion was corroborated by the earlier testimony of Bobby Steed Clark, a Senior Examiner with the Georgia Department of Insurance (A. 130). In Clark's opinion, Georgia Life should not have deducted from its A&H reserves the unearned premiums attributable to the policies purportedly ceded to Georgia Insurance. Clark based his opinion on the fact that the reinsurance contract did "not shift any risk of loss, because the assuming company is always guaranteed 4%" (A. 136). As support for his conclusion, Clark cited the National Association of Insurance Commissioners Handbook (Govt. Ex. 2, A. 196–267). Clark explained that under that Handbook, the arrangement between Georgia Life and Georgia Insurance was a surplus aid contract and not

a reinsurance contract because it did "not result in the transfer to the reinsurer of the corresponding risk or liability—which is the major characteristic of a legitimate reinsurance transaction" (Govt. Ex. 2, A. 230). Finally, Clark testified that the 1967 Georgia insurance examination report, which stated without elaboration that the reinsurance contract appeared to be in good order, was "contrary to all reporting standards and practices" (A. 148) and had neither been accepted nor disapproved by the Georgia Department of Insurance (A. 146–149).

The district court held that Georgia Life was entitled to reduce its own reserves for federal tax purposes by an amount corresponding to the unearned premiums reserve established by Georgia Insurance on the ceded share of A&H coverage. The court rested its conclusion on its view that Georgia Life had a legitimate business purpose for entering into the agreement, *viz.*, that the agreement would reduce its ratio of net written premiums to surplus so as to enable it to expand its business (Pet. App. B 17a). It acknowledged, however, that the only risk Georgia Insurance actually assumed under the reinsurance agreement was that claims on the quota share of ceded A&H coverage would exceed 96 percent of the premiums (over four times the average claims experience on such policies), and that even this "loss" would be recaptured from Georgia Life unless it became insolvent (Pet. App. A 13a—14a). The district court nevertheless entered judgment in petitioner's favor for $102,655.09, plus interest (A. 268).

The court of appeals reversed, with one judge dissenting (Pet. App. A 1a–7a). It held that the economic substance of the arrangement was that Georgia Life continued to bear the insurance risk, while Georgia Insurance "for a 4% fee, provided in effect a line of credit in case periodic claims reached abnormally high levels" (Pet. App. A 4a). Since Georgia Insurance "did not bear any risks except the outside possibility of insolvency of [Georgia Life]," the court of appeals concluded that "there was no substance to the agreement as reinsurance" (Pet. App. A 4a–5a).

In so holding, the court of appeals followed the decision of the Seventh Circuit in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466, certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending No. 74–701. In the court of appeals' view, the Seventh Circuit correctly concluded that "Congress intended * * * to charge the company *actually* experienced the risk of claim losses with the corresponding 'reserves'—for the purpose of determining who was in the insurance business—as opposed to the loan business [footnote omitted; emphasis in original]" (Pet. App. A 6a).

III. No. 75–1285

A. Respondent Penn Security Life Insurance Company was incorporated under the laws of Missouri as a wholly-owned subsidiary of Aetna Finance Company, the assets of which are now owned by a wholly-owned

subsidiary of International Telephone & Telegraph Corporation known as ITT Aetna Corporation [6] (Pet. App. 30a). Aetna made consumer loans through subsidiaries operating more than 200 finance company offices in approximately 25 states (Pet. App. 3a, 31a). In connection with its loan transactions, it was common for Aetna's borrowers to apply for and receive credit insurance to provide for repayment of their loans in the event of death or disability. During the years in question (1963–1965), this insurance was issued by three companies: Old Republic Life Insurance Company, Pilot Life Insurance Company, and National Fidelity Life Insurance Company (Pet. App. 3a–4a, 32a).

Under the life insurance provisions of these policies, the insurer was required to pay Aetna any outstanding balance of the loan in the event of the insured debtor's death. The accident and health (A&H) provisions required the insurer to pay loan installments falling due while the insured was totally disabled and unable to work. The terms of the coverage were coextensive with the term of the related loan (Pet. App. 4a).

A&H insurance was sold to Aetna's borrowers only together with life insurance. However, the amounts

[6] Respondent instituted this suit as ITT Hamilton Life Insurance Company (A. 5). Counsel for respondent now advises that, as a result of a merger, respondent has changed its name to Massachusetts Indemnity & Life Insurance Company. However, we will continue to refer to respondent as Penn Security Life Insurance Company.

of the A&H insurance premiums were separately stated. All premiums were required to be paid in full by the insured debtor at the inception of the policy term (Pet. App. 33a, 39a–40a).

Respondent was organized by Aetna for the purpose of reinsuring the credit insurance coverage issued to Aetna's loan customers by Old Republic, Pilot, Nationl Fidelity and other companies. During 1963–1965, the taxable years at issue, respondent's business primarily consisted of reinsuring such risks pursuant to reinsurance agreements ("treaties") with Old Republic, Pilot and National Fidelity (Pet. App. 3a, 4a, 40a).

As in the case of Treaty I in No. 75–1221, respondent assumed the entire insurance risk under its reinsurance treaties by agreeing to reinsure 100 percent of the liability of each company with respect to life insurance and A&H insurance issued to Aetna and its borrowers. In exchange for assuming the insurance risk, respondent received the premiums paid thereon less a two percent commission to be retained by the issuing companies.[7] The treaties provided for the payments of reinsurance premiums with respect to life insurance coverage as they were received by the issuing companies (Exs. 1, 3, 5, A. 61–65, 73–78, 86–90). However, the A&H insurance premiums were paid to respondent on a monthly basis, and such payments represented that portion of the premiums al-

[7] Old Republic retained an 11 percent commission (Pet. App. 40a).

locable to the prior month's A&H coverage (Pet. App. 4a–5a, 40a; Exs. 2, 4, 6, A. 66–72, 79–85, 91–96).

Respondent was generally entitled to receive 98 percent of the premiums earned with respect to credit A&H insurance in force during the previous month. Thus, for example, if the issuing company received a $360 A&H premium on January 1, 1963, with respect to a 36-month policy, 1/36th of this premium ($10) would be allocable to coverage for the month of January and $9.80 would be paid over to respondent during the month of February (Pet. App. 5a, 40a–41a). Under the reinsurance treaties, respondent was liable to the issuing companies for the benefits covered by reinsurance to the same extent as the issuing companies were liable to the persons insured for such benefits. As a result, whenever a claim was made under a policy reinsured by respondent, respondent was required to consider it to be a claim for the full amount of reinsurance on the policy (Pet. App. 42a–43a).

For each of the years 1963, 1964, and 1965, respondent filed an annual statement with the Missouri Division of Insurance. These annual statements did not reflect any unearned premium reserves with respect to the A&H policies issued by Old Republic, Pilot, and National Fidelity and reinsured by respondent under its reinsurance treaties with those companies (Pet. App. 46a–47a). After audits by the Missouri Division of Insurance in 1965 and 1969, respondent was not required to establish unearned premium reserves with respect to the A&H insurance risks it assumed under the reinsurance agreements with Old

Republic, Pilot and National Fidelity (Pet. App. 47a–48a).

B. For each of its taxable years 1963, 1964, and 1965, respondent claimed the preferential tax treatment accorded life insurance companies on its federal income tax returns. Respondent took the position that it met the Section 801(a) definition of a "life insurance company" because its "life insurance reserves" exceeded 50 percent of its total reserves as reflected on its annual statements filed with the Missouri Division of Insurance (Pet. App. 37a).

Respondent thereafter claimed refunds of part of the taxes it paid for 1963–1965 on the ground that it was entitled to deduct certain losses in connection with the computation of its reserves. However, the Commissioner disallowed the refund claims. After respondent filed a petition in the Court of Claims seeking a refund of taxes paid on the basis of its subsequently claimed deductions, the Commisioner determined deficiencies of $965,774.95 for these years, based upon his conclusion that during those years respondent did not qualify for the preferential tax treatment accorded to life insurance companies. The Commissioner's determination was based upon his inclusion of the reserves for the A&H risks ceded to respondent in its "total reserves" under Section 801(c) because respondent had assumed the insurance risk on those policies. As a result, respondent's life insurance reserves did not comprise more than 50 percent of its total reserves as required by Section 801(a) (Pet. App. 8a, 57a–58a; A. 52).

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Respondent paid the deficiencies and sought their refund in the suit it had already commenced in the Court of Claims (Pet. App. 8a–9a).[8] Over the dissent of the same judge who dissented in No. 75–1221 (see pp. 16–17, *supra*), the Court of Claims adopted its trial judge's recommended decision that the A&H insurance reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(e)(2) of the Code because the various issuing companies were in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under the reinsurance treaties (Pet. App. 13a–21a).

The court concluded that respondent did not have to include the A&H insurance reserves as part of its total reserves because each monthly payment of A&H premiums made to respondent by the issuing companies represented premiums allocable to coverage for the prior month so they were not "unearned premiums" within the meaning of Section 801(e)(2) of the Code. In so holding, the court rejected the contrary conclusion on similar facts of the Seventh Circuit in *Econ-*

[8] The provisions of the Old Republic treaty differed from those of the Pilot and National Fidelity treaties as to the effect of termination upon insurance in force. In order to dispense with the need to consider the legal effect, if any, of such differences and because the A&H reserves with respect to the Old Republic treaty made no difference to the outcome of this case, the government agreed in the court below that they could be disregarded in computing respondent's total reserves (Pet. App. 38a).

omy Finance Corp. v. *United States*, *supra*, 501 F. 2d 466, certiorari denied, 420 U.S. 947, motion for leave to file a second and untimely petition for rehearing pending, No. 74–701 (Pet. App. 13a–19a).

The court also ruled that the A&H reserves were not includable in respondent's "total reserves" as "other insurance reserves required by law" under Section 801(e)(3) of the Code because the Missouri Insurance Department did not take any action against respondent to require it to establish reserves for the A&H coverage it reinsured.[9] Accordingly, the court held that respondent qualified as a "life insurance company" under Section 801(a) of the Code (Pet. App. 21a–22a).

In concluding that the A&H reserves were properly attributable to respondent, the dissenting judge stated that "[respondent] maintains the reserves for purposes of the 801(a) test, though for no other purposes, because it has arranged, itself or through its affiliates, and using the economic leverage they jointly possess, to have these reserves available to satisfy the right of the [A&H] policyholders to have their risks covered by legally acceptable reserves" (Pet. App. 29a–30a).

[9] The court therefore found it unnecessary to reach the alternative contention raised by respondent (which the Seventh Circuit rejected in *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 482–483) that only the "morbidity" portion of A&H premiums should be taken into account in attributing A&H reserves for purposes of determining "total reserves" under Section 801(e).

SUMMARY OF ARGUMENT

1. Under the Internal Revenue Code of 1954, life insurance companies enjoy the preferential tax treatment of a narrowed tax base. Other stock insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are generally taxable on their total annual net income. These cases present the question whether the taxpayer insurance companies are eligible for life insurance company status.

The precise issue focuses upon the application of the reserve-ratio test of Section 801(a) of the Code. Like the taxpayers, many life insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. Section 801(a) provides an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose predominant business is the assumption of life insurance risks.

The reserve-ratio test requires the calculation of the following fraction—

$$\frac{\text{Life Insurance Reserves}}{\text{Total Reserves}}$$

and restricts life insurance company status to those companies whose reserve ratios exceed 50 percent. The controversy in these cases is whether certain cancelable accident and health insurance reserves are includable in the taxpayers' "total reserves," *i.e.*, the denominator of the fraction. If they are so includable, the taxpayer companies' reserve ratios will be less than 50 percent, so as to disqualify them from preferential life insurance company tax treatment.

2. In these three cases, the taxpayers entered into reinsurance arrangements that attempted to shift the accident and health insurance reserves to other companies on a temporary basis in order to become eligible for life insurance company status. But under each of the two types of arrangements at issue, the taxpayers continued to bear the ultimate insurance risk under the accident and health coverage because the policyholder claims were paid from the very premium dollars that were temporarily held by the other companies on behalf of the taxpayers. As the Seventh Circuit concluded in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466, 478, certiorari denied, 420 U.S. 947, with respect to a virtually identical arrangement, the role of the other companies was simply that of a paymaster for which they received a small commission.

Thus, the form of the arrangements cannot mask the economic reality that the taxpayers at all times bore the ultimate liability to the accident and health policyholders. Since the essence of insurance is risk-shifting (*Helvering* v. *LeGierse,* 312 U.S. 531, 539) and the purpose of an insurance reserve is to meet claims under the policies, the accident and health reserves are includable in the taxpayers' "total reserves" under Section 801(c). Simply put, the reserves can only be attributed to the company that assumes the corresponding insurance risk.

3. The statutory language of Section 801(c) supports the inclusion of the accident and health insurance reserves in the taxpayers' "total reserves." Section 801(c)(2) requires the inclusion of "unearned premiums" in a company's "total reserves." The terms and legislative history of the reserve ratio test of Section 801 demonstrate that it is designed to measure the predominant element of a company's insurance business by the yardstick of reserves. Thus, every item to be included in the computation of "total reserves" necessarily is a type of insurance reserve and not a type of asset. The statutory term "unearned premiums" therefore refers to the unearned premium reserves of the accident and health coverage by which potential liability under non-life insurance is traditionally measured. While that measure is mathematically equal to the "unearned" portion of the gross premiums paid by the policyholder, the reserve is not conceptually equivalent to the premium dollars themselves.

The fundamental error of the Court of Claims' ruling that the accident and health reserves were not attributable to the taxpayers was to confuse the concept of "unearned premium reserve" with the unearned premiums themselves. The unearned premium *reserve* represents the potential liability to the policyholder and can therefore only be attributed to the company that bears the liability, *viz.*, the reinsurer of the risk. However, the unearned premiums are the amount of premium dollars collected that are allocable to periods of future coverage.

A company that simply holds unearned premiums on behalf of another company until they are earned cannot include the equivalent amount in a reserve for "unearned premiums" under Section 801(c)(2) unless it has the ultimate liability to meet the policyholder claims. Since the taxpayers had the ultimate liability for the accident and health policy claims, the "unearned premiums" are attributable to them in computing their "total reserves" under Section 801(c).

4. The inclusion of the accident and health reserves in the taxpayers' "total reserves" is also confirmed by the applicable state law as both "unearned premiums" under Section 801(c)(2) and as "other insurance reserves required by [state] law" under Section 801(c)(3). In rejecting this basis for inclusion of the accident and health reserves, the Court of Claims rested its decision in part upon the fact that neither the Georgia, Arizona nor Missouri state insurance authorities took any action against the taxpayers' failure to establish such reserves for state reporting purposes. But any reliance upon state examiners' inaction is unjustified in the face of the uncontradicted testimony of the state insurance officials in No. 75–1221 (*Consumer Life*) that their failure to act was a consequence of their unfamiliarity with these arrangements.

Finally, the language of the pertinent state insurance statutes demonstrates that the taxpayer companies were required to establish unearned premium reserves for the accident and health coverage under both the reinsurance arrangements at issue here. Thus, the applicable state law is in accord with the general

rule that we urge in these cases, *viz.*, that the insurance reserves follow the insurance risk.

ARGUMENT

AN INSURANCE COMPANY DOES NOT QUALIFY FOR TAXATION AS A LIFE INSURANCE COMPANY UNLESS ITS LIFE INSURANCE RESERVES EXCEED 50 PERCENT OF THE TOTAL RESERVES ATTRIBUTABLE TO POLICIES UPON WHICH IT BEARS THE ULTIMATE INSURANCE RISK

A. INTRODUCTION

These cases involve the application of the familiar axiom that economic substance rather than form is controlling for purposes of federal taxation. The rule rests upon the well-established principle that taxation is a practical matter that is not so much concerned with the labels put upon a transaction by the parties as it is with the actual import of the arrangement. If the labels are at odds with the economic reality, the courts have not hesitated to disregard them in determining the tax consequences of a contractual relationship.

Since the enactment of the modern income tax system in 1913, this Court has applied the substance-over-form doctrine in a number of landmark decisions that have been a major influence in shaping the development of our federal tax jurisprudence. Thus, for example, the Court has held that a taxpayer who is entitled to receive income and makes a gift of it by an anticipatory assignment, realizes taxable income just as if he had collected the income and paid

it over to his donee. See, *e.g.*, *Lucas* v. *Earl,* 281 U.S. 111; *Helvering* v. *Horst,* 311 U.S. 112; *United States* v. *Basye,* 410 U.S. 441.

Lucas v. *Earl, supra,* is the seminal precedent. In rejecting the attempt of a taxpayer to deflect one-half of his future earned income to his wife by contract and thereby reduce his overall tax liability under the graduated rates, the Court stated (281 U.S. at 114–115):

> [T]his case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

The Court has likewise set aside temporary assignments of income when the donor retains the ownership of the income-producing property (*Helvering* v. *Clifford,* 309 U.S. 331; *Corliss* v. *Bowers,* 281 U.S. 376); denied interest deductions where there was no economic borrowing (*Knetsch* v. *United States,* 364 U.S. 361); and imposed estate taxation in accordance with "the nature and operative effect of [a reciprocal]

trust transfer" (*United States* v. *Estate of Grace,* 395 U.S. 316, 323). Indeed, in *Gregory* v. *Helvering,* 293 U.S. 465, the Court refused to give effect to a corporate transaction that met all of the requirements of a tax statute because "[t]he whole undertaking * * * was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else" (293 U.S. at 470). As the Court there concluded (*ibid.*), "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision * * * of all serious purpose."

Stripped of their technical insurance terminology, these cases involve the application of a specific and detailed Code provision that embodies the principle of substance over form. Suppose, for example, A has accounts receivable and engages B to collect them for him on a commission basis, pay certain of A's obligations out of the receipts, and remit the balance to A at stated intervals. It requires no citation of authority that, as a matter of economic substance, the receipts and disbursements from the fund are attributable to A for tax purposes, notwithstanding B's physical possession and nominal control over the fund. Thus, if B were to establish a reserve for bad debts on its books to take into account estimated worthless receivables, B's additions to that reserve would be reflected as deductions on A's tax return because the estimated losses would be A's losses and not those of B. The role of B is simply that of a commission agent or bookkeeper.

The taxpayers in these cases stand in the place of A

in the foregoing example. They contend, and the Court of Claims has held in two of the three cases under review, that insurance reserves that are analogous to the bad debt reserves in the example, are attributable for tax purposes to companies standing in the place of B. Simply put, the question presented is whether an insurance company can temporarily shift the premiums on its non-life business to another company so as to preserve its qualification as a company whose predominant business is life insurance, and yet continue to profit from and bear the risk of loss on the non-life business by ultimately receiving the non-life premiums less claims paid.

It is our position that the contractual arrangements between the taxpayers and the other companies in these cases did not shift their non-life reserves to those other companies. The terms of the statutory definition of a "life insurance company," to which we now turn, confirm that the predominant element of the taxpayers' business was non-life insurance throughout the taxable years at issue so as to disqualify them from preferential life insurance company tax treatment.

B. THE LANGUAGE OF SECTION 801(C) SUPPORTS INCLUSION OF THE ACCIDENT AND HEALTH RESERVES IN THE TAXPAYERS' "TOTAL RESERVES"

Section 801(a) defines a "life insurance company" as an insurance company whose "life insurance reserves" comprise more than 50 percent of its "total

reserves." Section 801(c) in turn defines the term "total reserves" to mean—

> (1) life insurance reserves,
>
> (2) *unearned premiums,* and unpaid losses (whether or not ascertained), not included in life insurance reserves, and
>
> (3) all other insurance reserves required by law [emphasis supplied].

In these cases, the taxpayers entered into two types of reinsurance arrangements that attempted to shift their non-life (accident and health) reserves to other companies. While we discuss the details of each of the two transactions in Part D, *infra,* pp. 51–66, the essential element of both arrangements was to have another insurance company temporarily hold non-life premiums on which the taxpayers bore the insurance risk and pay them over to the taxpayers (less claims paid) after they were "earned," *viz.,* after the expiration of the period of coverage to which they were allocable. Thus, if the single premium was $120 per year payable on January 1, the other company would pay over to the taxpayers the $10 attributable to the January coverage on or after February 1.

The taxpayers contend, and the Court of Claims held in *Consumer Life* and *Penn Security,* that the payment of the non-life premiums to them on a delayed basis shifted the reserves on the accident and health coverage to the other companies because they received the non-life premiums only after they were "earned." Their argument relies on the statutory term "unearned premiums" in Section 801(c)(2). Since the other companies held the premiums during the period

they were "unearned," the taxpayers urge that they had no "unearned premiums" attributable to non-life coverage to be included in their "total reserves."

The structure and terminology of Section 801(c), viewed in the light of accepted insurance concepts, demonstrate the fallacy of this reasoning, which confuses a reserve liability account with the premium dollars themselves. Section 801(c) defines the types of reserves that are to be included in determining a life insurance company's "total reserves," in order to ascertain whether the life insurance reserves exceed 50 percent of total reserves. The definition, like the standard in Section 801(a), deals with a single subject: reserves. Its purpose is to distinguish the reserves that are to be included as a part of total reserves from those that are to be excluded.

For example, a life insurance company's total reserves might include many non-insurance reserves, such as that for depreciation of its building and equipment. The definition in Section 801(c) makes it explicit that the "total reserves" for purposes of Section 801(a) are limited to those involved in the insurance aspects of the business and to such of the latter as the definition covers.

In other words, the three subcategories in Section 801(c)—life insurance reserves, unearned premiums and unpaid losses, and all other insurance reserves required by law—specify three general types of insurance reserves, not two types of reserves and one type of asset. The term "unearned premiums," as used in Section 801(c)(2), is one of those types of reserves.

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"Unearned premiums" connotes the unpaid premium *reserve* which traditionally represents the measure of the liability of an insurance company to meet claims for short-term casualty coverage. See Hammond, *Insurance Accounting Fire and Casualty,* p. 177 (2d ed. 1965). That term does not, as the Court of Claims erroneously believed, refer to the actual premium dollars on hand during the period of coverage. As the Court of Claims previously observed with respect to casualty insurance, "Every insurance company sets up a *reserve for unearned premiums,* but this is not done in anticipation of the possibility that some part of the premiums will have to be returned, but *to take care of anticipated losses on the policies.*" *Colonial Surety Co.* v. *United States,* 178 F. Supp. 600, 602 (Ct. Cl.) (emphasis supplied).

Similarly, the term "unpaid losses" in Section 801(c)(2) refers to another type of insurance reserve which represents the company's liability to recognize losses that have occurred. See Hammond, *Insurance Accounting Fire and Casualty,* p. 148. This is further confirmed by the modifying phrase "not included in life insurance reserves" immediately after "unpaid losses." The use of this modifying phrase demonstrates that the term "unpaid losses" in Secion 801 (c)(2) connotes a reserve for unpaid losses with respect to non-life insurance.

Finally, Section 810 of the Code offers additional statutory evidence that the term "unearned premiums" refers to the unearned premium reserve. In prescribing rules for various reserves, Section 810

(c)(2) provides that "unearned premiums and unpaid losses included in total reserves under section 801 (c)(2)" are to be taken into account in making upward and downward adjustments to reserves.

In these circumstances, it is immaterial that Congress used the word "reserves" in formulating the definitions in subsections (1) and (3) of section 801 (c), but did not speak of "unearned premium reserves" and "unpaid loss reserves" in subsection (2). There is no reason to suppose that when Congress defined what types of reserves it intended to include in "total reserves," it intended subsection (2) to mean anything other than its obvious context, *i.e.,* reserves for unearned premiums and unpaid losses. The most likely explanation for the failure of Congress to use the term "reserves" in defining the second category of "total reserves" was that, as indicated above, in the insurance business "unearned premiums" and "unpaid losses" ordinarily are viewed connoting the reserves for those items.

The phrase "unearned premiums" therefore refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims. If, as we shall demonstrate, the taxpayer companies continued to bear the risk of meeting claims under the accident and health coverge, the accident and health unearned premium reserves attributable to such coverage must be included in their "total reserves" under the statute, despite the temporary physical possession of the unearned premium dollars by the other companies.

C. THE 50 PERCENT RESERVE RATIO TEST OF SECTION 801 (a) RESTS UPON THE PRINCIPLE THAT INSURANCE RESERVES ARE ATTRIBUTABLE TO THE COMPANY THAT ASSUMES THE CORRESPONDING RISKS

1. Under the Internal Revenue Code of 1954, life insurance companies enjoy tax treatment that is markedly more favorable than that of other types of insurance companies.[10] The structure and operation of the present statutory system for the taxation of life insurance companies are summarized in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235–238, and *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 844–846 (C.A. 4), certiorari denied, 396 U.S. 828. For present purposes, it is sufficient to state that Sections 801–820 of the Code provide a special three-phase procedure for the taxation of life insurance companies that considerably narrows their tax

[10] Special tax treatment for life insurance companies originated in Sections 242–247 of the Revenue Act of 1921, 42 Stat. 261–264. Prior to 1921, all types of insurance companies were taxed in the same manner as other corporations on all of their net income, except that they were allowed a special deduction for the "net addition required by law to be made within the taxable year to reserve funds * * *." See Section 234(a)(10) of the Revenue Act of 1918, c. 18, 40 Stat. 1057. Between 1921 and the enactment of the present Code provisions dealing with the taxation of life insurance companies, such companies were taxable on only part of their investment income and none of their underwriting income. See generally *A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies*, Hearings on Federal Taxation of Life Insurance Companies before a Subcommittee of the House Committee on Ways and Means, 83d Cong., 2d Sess., pp. 3, 18–22 (1955); and H.R. Rep. No. 34, 86th Cong., 1st Sess., pp. 1–5 (1959).

base. Pursuant to Section 802(b), the total tax base of a life insurance company to which the ordinary corporate rates are applied is the sum of the tax bases derived from computations under each of the three phases.

The Phase I tax base (Section 802(b)(1)) is the smaller of "taxable investment income" or "gain from operations." The Phase II tax base is equal to 50 percent of the excess, if any, of the gain from operations over taxable investment income (Section 802(b)(2)). Finally, the deferred portion of underwriting income that is not taxed under Phase II becomes the Phase III tax base when such income is made available to shareholders (Section 815).

On the other hand, stock insurance companies other than life insurance companies, such as those engaged in the sale of cancellable accident and health insurance and other forms of casualty insurance, are generally taxable on their total annual net income as any other corporation. See Sections 831 and 832 of the Code.

"Historically and commonly insurance involves risk-shifting and risk-distributing." *Helvering* v. *Le-Gierse*, 312 U.S. 531, 539. The difference between the tax treatment of a life insurance company and other types of insurance companies reflects the distinction between life and non-life risks.

Life insurance contracts generally involve the assumption of long-term risks that increase over the period of coverage and that will ultimately require the payment of a claim. In order to provide for the certainty of the death of its policyholders, the company

must accumulate a fund from the investment of premiums. The company's liability to its policyholders for this fund, computed on the basis of a recognized table and an assumed rate of interest, constitutes the "reserve" that the company must have on hand against its outstanding policies. See *Williams* v. *Union Central Life Ins. Co.*, 291 U.S. 170, 177. Thus, the three-phase tax computation established by Congress in 1959 recognizes that such companies are required to maintain policyholder reserves to meet future claims and that the annual increments to the reserves should be free of tax.

Moreover, the long-term risk inherent in life insurance makes it difficult to measure the "profit" of a life insurance company within the relatively short time frame of a single taxable year. In any given year, benefits paid could either be greater or less than the amounts that had been estimated under the actuarial tables As a result, Congress has permitted life insurance companies to defer the tax upon 50 percent of their underwriting income until it is distributed to its shareholders See H.R. Rep. No. 34, *supra,* pp. 2–4; S. Rep. No. 291, 86th Cong., 1st Sess., pp. 3–7 (1959).

The foregoing considerations are not applicable to cancellable accident and health insurance because that type of coverage does not involve the assumption of long-term risks for which the payment of benefits is certain to occur many years in the future. Unlike life insurance, the reserves for short-term casualty insurance do not involve the accumulation of reserves at an assumed rate of interest but are simply measured by the premiums themselves. Thus, in the case of casualty

insurance such as the accident and health coverage involved in these cases, the reserve is measured solely by the unearned premiums, *i.e.,* that portion of the premiums attributable to periods of future coverage without regard to income assumed to be generated by the premiums. If the premium is $120 per year, paid as of December 1, the unearned premiums reserve as of December 31 is $110. Finally, because of the short-term nature of its cancellable risks, a casualty insurance company can measure its taxable income with reasonable accuracy in any given year by including in income its earned premiums collected and deducting its insurance reserves, the claims paid, and its other expenses of operation.

As a result, Congress has consistently provided for taxation of such non-life insurance companies in much the same manner as any other corporation. See Sections 831 and 832 of the Code.

2. Once it is recognized that the preferential tax treatment accorded to life insurance companies is premised upon the special characteristics of life insurance risks, it is apparent that a company's eligibility for life insurance company status necessarily turns on whether it in fact assumes life insurance risks. Suppose, for example, a company issues only life insurance policies but thereafter transfers all of the risks under such policies to another company under a reinsurance agreement, retaining only a commission for itself. Under those circumstances, the issuing company is simply a commission agent and not a life insurance company because it has parted completely with the

risk of insurance. Conversely, if the issuing company retains the life insurance risks but engages another company for a fixed fee to administer the collection of premiums and the payment of claims and to pay over the balance to the issuing company, the issuing company is a life insurance company because it enjoys the benefits and bears the burdens of the life insurance business.

Like the companies in these cases, many insurance companies do not deal exclusively in either life or non-life insurance but in a combination of the two types of policies. It was therefore necessary to devise a method for determining how to tax such "mixed" enterprises. Thus, as early as Section 242 of the Revenue Act of 1921, 42 Stat. 261, Congress established an objective mathematical test designed to limit the preferential life insurance company tax treatment to those companies whose life insurance reserves "comprise more than 50 percentum of its total reserve funds." As Dr. T. S. Adams, Tax Advisor to the Treasury Department, explained to the Senate Finance Committee in 1921 (Hearings on H.R. 8245, Internal Revenue, before the Senate Committee on Finance, 67th Cong., 1st Sess., p. 85 (1921)):

> Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that *if this accident and health business was more than 50 percent of their business, as measured by their reserves,* it could not be treated as a life insur-

> ance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company [emphasis supplied].

Since 1921 an insurance company has been taxed as a life insurance company only if its predominent business is the assumption of life insurance risks. See, *e.g., National Protective Ins. Co.* v. *Commissioner,* 128 F. 2d 948, 950 (C.A. 8), certiorari denied, 317 U.S. 655; *New World Life Insurance Co.* v. *United States,* 26 F. Supp. 444, 461 (Ct. Cl.), affirmed on another issue, 311 U.S. 620; *Commissioner* v. *Monarch Life Ins. Co.,* 114 F. 2d 314, 324–325 (C.A. 1).

In tying life insurance company status to life insurance reserves, the foregoing excerpt from the legislative history demonstrates that Congress employed the reserves concept as the proper measure of the amount and character of a company's insurance business for purposes of determining its tax status. As the Court of Claims has previously stated, "it was the character of an insurance company's business *as measured by its policy reserves* that served as the touchstone for the definition of 'life insurance company.'" *Alinco Life Inc. Co.* v. *United States,* 373 F.2d 336, 347 (emphasis in original). Since the function of insurance reserves is to provide a fund to meet future policyholder claims, the reserves will be an accurate gauge of the business only of the company that assumes the economic risk of meeting the claims under the policies attributable to the reserves, ~~viz.~~ viz., the com-

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pany and that makes the profits or suffers the losses from assuming that risk.

In short, for purposes of measuring the predominant element of the business of an insurance company engaged in issuing different types of risks by the yardstick of reserves, the reserves must be attributed to the company that actually assumes the insurance risk on the corresponding policies.

Section 801(a) of the 1954 Code, the terms of which we have previously analyzed (*supra,* pp. 37–41), continues essentially the same 50 percent reserve ratio test first set forth in Section 242 of the 1921 Act. Under Section 801(a), a "life insurance company" is defined as an insurance company whose life insurance reserves plus its unearned premiums and unpaid losses on noncancellable life, health or accident policies [11] comprise more than 50 percent of its total reserves. Section 801(c) in turn defines the term "total reserves" as consisting of: (1) life insurance reserves; (2) unearned premiums and unpaid losses not included in life insurance reserves; and (3) all other insurance reserves required by law.

[11] The taxpayers in these cases have not contended that the accident and health policies were "noncancellable life, health, or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Under the accident and health coverage in question, the insured did not have a guaranteed option to renew on the expiration of the initial term. Thus, it was not "noncancellable" within the meaning of the statute. See *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480–482; *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945, 951 (C.A. 4).

During the years in question, the taxpayers in these cases were engaged in the business of insuring both credit life and credit accident and health (A&H) risks. In each instance, the predominant element of their business, as measured by the respective reserves appropriate to the two types of polices, was the assumption of non-life A&H risks. Thus, had the taxpayers directly established unearned premium reserves appropriate to the A&H risks they assumed and included such amounts in their "total reserves"—the denominator of the Section 801(c) reserve ratio—it is undisputed that they would have failed to meet the 50 percent test of Section 801(a) and would therefore have been ineligible for the preferential life insurance company tax treatment. However, in an attempt to keep their A&H reserves below 50 percent of their total reserves, each taxpayer entered into contracts that purported to shift the A&H reserves to other companies by arranging for the other companies to hold the advance A&H premiums until such time as they were "earned," *i.e.,* until the expiration of the period of coverage attributable to such reserves.[12]

[12] Apart from the tax-avoidance motivation for these transactions, petitioner First Railroad introduced testimony that its Treaty II-type arrangement was intended to spread the risk which would enable it to expand the volume of A&H business (No. 75–1260—A. 66–67). But as Professor Zelten explained, the agreement should not have been given the effect of divesting Georgia Life of the full reserve for unearned premiums on the A&H policies, and should not have enabled it to expand its business because (1) it did not actually reduce the risks to which the company was subject, and (2) it adversely affected the company's true financial status by permanently shifting four percent of premiums paid to Georgia Insurance (A. 154–156, 159–163).

The various contractual arrangements between the taxpayers and the other companies did not shift the A&H reserves to those other companies. The fact that the A&H premium dollars were not physically paid over by the other companies to the taxpayers until they were "earned" does not justify the Court of Claims' conclusion that the reserves based upon "unearned premiums" were attributable to those other companies. Indeed, "physical possession" of the premiums is something of an anomaly in our modern economy where money is largely represented by bank deposits and similar intangible claims. The taxpayers in these cases had the same claims to the unearned premiums that they would have had to time deposits in a bank. They were therefore equally an asset to the taxpayers, calling for the establishment of a corresponding reserve.

The function of an insurance reserve is to represent the insurer's estimated liability to the policyholders. Since the obligation to meet A&H policy claims was borne by the taxpayers throughout the periods of coverage by their assumption of the insurance risk, the unearned premium reserves reflecting that obligation were properly attributable to the taxpayers and not to the other companies. Thus, to conclude that the A&H reserves should be attributed to the companies that temporarily held the premiums in exchange for a commission would elevate the "attenuated subtleties" of bookkeeping formalities over the substance of the

insurance business represented by the assumption of the insurance risk.

D. THE REINSURANCE ARRANGEMENTS IN THESE CASES DID NOT SHIFT THE ACCIDENT AND HEALTH RESERVES FROM THE "TOTAL RESERVES" OF THE TAXPAYER COMPANIES TO THE OTHER COMPANIES THAT WERE PARTIES TO THE ARRANGEMENTS BECAUSE THE TAXPAYERS BORE THE ULTIMATE INSURANCE RISK ON THE ACCIDENT AND HEALTH POLICIES

As the foregoing portion of this brief demonstrates, the reserve ratio test of Section 801(a) is designed to measure the relative quantities of the various types of a company's insurance business and to accord life insurance company status only to those companies whose life insurance business is the dominant element. Since the essence of insurance is the assumption of risks, the test can only accurately measure the predominant element of a company's business if the reserves are attributed to the company that assumes the insurance risks reflected by the reserve.

We do not suggest that once a company assumes an insurance risk and establishes a reserve to meet claims, it can never transfer the risk to another company. Such a transfer is commonly achieved by means of a contract or treaty of reinsurance. Under such arrangements, the original insurer (called the ceding company) agrees to transfer and the reinsurer agrees to accept all or a fixed share of a risk for a certain consideration.

But just as the fundamental attribute of insurance is the assumption of a risk, the *sine qua non* of reinsurance is the transfer of a risk. As a widely-used authority states, "[t]he essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance." National Association of Insurance Commissioners, *Examiners Handbook,* Part B, p. B6 (1970 ed.) (Govt. Ex. 2, No. 75–1260—A. 211). See also *id.* at pp. B23–B24 (No. 75–1260—A. 249–253).

The question therefore is whether the various arrangements in these cases were in fact reinsurance agreements, *i.e.,* did they transfer a risk from the ceding company to the reinsurer. Our analysis focuses upon the two reinsurance treaties (I and II) involved in No. 75–1221 (*Consumer Life*) because they are representative of the arrangements in all three cases.

1. *Treaty I.* Pursuant to Treaty I, respondent Consumer Life reinsured the risk on all credit life and A&H insurance directly issued by American Bankers to individuals obtaining loans from respondent's parent. The treaty provided that respondent would reimburse American Bankers "for all losses actually paid on [both] Life policies * * * and Health and Accident policies * * *" approximately 40 days after American Bankers' submission of its monthly statement (Pet. App. B 113a–114a). Respondent therefore freely conceded in the court below (A. 130–133), and the court so found (Pet. App. B 70a), that it assumed the entire

insurance risk on both the life and A&H insurance.[13] In exchange for the assumption of these risks, respondent received 87½ percent of the premiums collected by American Bankers (Pet. App. B 70a–71a, 113a–114a).

As the direct insurer, American Bankers collected all of the single payment premiums in advance and initially paid all claims under the policies. Each month American Bankers paid over to respondent its full share of all life insurance premiums received by it during the preceding month. However, with respect to the A&H premiums, American Bankers remitted to respondent each month only that portion of the premiums that was ratably allocable to the coverage for the prior month.

For example, if American Bankers collected $120 in A&H premiums for a one-year policy on January 1, it would not pay over to respondent the $10 allocable to the January coverage (less its 12½ percent commission) until February 1. The payment attributable to the February installment would be paid on March 1, and so on. Thus, while respondent received its share

[13] In its brief in opposition (p. 2), Consumer Life denies it conceded that it assumed the entire risk on the life and A&H policies under Treaty I. But the record shows that respondent's counsel explicitly acknowledged that "ultimately way on out many, many months or years, 100 percent of the risk would be borne by Consumers. There's no question about that" (A. 131). Shortly thereafter, he likewise stated that "ultimately they [Consumer Life] still have that 100 percent exposure on that loss, but the only question is when they are liable for it" (A. 132). There is accordingly ample support for the Court of Claims' finding (Pet. App. B 70a).

of life insurance premiums almost immediately upon issuance of the policies, it received its share of the A&H premiums only after the periods of coverage attributable to the premiums had expired (Pet. App. B 70a–71a, 110a–117a).

a. Under the settled definition of reinsurance, Treaty I, as well as its essentially parallel counterpart in No. 75–1285 (*Penn Security*),[14] is a true reinsurance agreement because American Bankers transferred the insurance risk to respondent Consumer Life. Apart from respondent's concession that this was the case, the agreement explicitly stated that respondent would reimburse American Bankers for all losses paid on the policies. Thus, American Bankers' role was that of a paymaster; it collected the premiums and disbursed the claims. Consumer Life indemnified American Bankers for the claims and thereby bore the economic burden of meeting them.

All of this is clear with respect to the life insurance premiums. Indeed, respondent Consumer Life implicitly admits that it assumed the risk of the life insurance written by American Bankers, because it claims the reserves attributable to those policies as its life insurance reserves for purposes of the Section 801(a) reserve ratio test. However, respondent contends and the Court of Claims held that the A&H

[14] The only difference between Treaty I and the various reinsurance treaties involved in No. 75–1285 was that, in the latter case, respondent Penn Security was generally entitled as reinsurer to receive 98 percent of the premiums earned with respect to the A&H insurance in force for the preceding month (Pet. App. 42a–43a).

reserves were not includable in its "total reserves" because it did not physically receive its share of the A&H premiums until after the expiration of the period of coverage to which the premiums were allocable. In the Court of Claims' view, the A&H reserves were part of American Bankers' "total reserves" under Section 801(c)(2) because American Bankers held the A&H premiums until they were "earned."

The difference in timing between American Bankers' transmission of the life and of the A&H premiums to Consumer Life does not warrant a different federal tax result where the ultimate destination of those premiums was provided for at the outset. As we have noted earlier, "physical receipt" is something of an anomaly in the context of funds to which Consumer Life had a contractual right. "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613. From Consumer Life's standpoint, it was obligated to reimburse American Bankers for claims paid with respect to *both* the life and A&H coverage. Thus, the fact that Consumer Life received the A&H premiums on a one-month delayed schedule cannot serve to shift the A&H reserves to American Bankers when Consumer Life in fact had the right to receive the A&H premiums reflected by those reserves and employed American Bankers to use them to indemnify itself for its initial payments of policy claims.

When American Bankers paid A&H claims, it was doing so on behalf of Consumer Life and not on its own account. Since the purpose of an insurance reserve is to meet estimated policy claims, the A&H reserves are properly attributable to Consumer Life because it and not American Bankers met the claims under the A&H insurance. The paymaster role of American Bankers is therefore an insufficient basis for attribution to it of the A&H reserves because it put none of its own assets at the risk of the A&H insurance business.[15] As the Seventh Circuit observed in *Economy Finance Corp.* v. *United States, supra,* 501 F. 2d at 478, in characterizing the role of a company analogous to American Bankers in an arrangement virtually identical to Treaty I: "[It] performed a banking and clearing house function and not an insurance function."

Because American Bankers paid the A&H claims on behalf of Consumer Life and not on its own account,

[15] A variation on the Treaty I-type arrangement was involved in *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). There, the taxpayer issued credit life and credit A&H policies with respect to loans made by its parent, which acted as the sales agent for such policies. The parent immediately paid over the life premiums to the taxpayer, but, as in the case of Treaty I, remitted the A&H premiums on a monthly basis as "earned." While the case did not involve a reinsurance agreement, the effect of the arrangement, which the court held insufficient to shift the A&H reserves to the parent for purposes of the reserve ratio test, is essentially the same as that of the Treaty I-type arrangements in these cases. While the court rested its decision in part upon the agency relationship of the parties (*id.* at 950), the instant cases are essentially identical because of the taxpayers' contractual right to the A&H premiums less claims and commissions.

a useful non-insurance analogy to these cases is *Commissioner* v. *Hansen*, 360 U.S. 446. There, accrual basis automobile dealers had sold customer installment obligations to finance companies. Because the finance companies were unwilling to assume the risk that the customers would not pay on the notes, they required the dealers to reimburse them for losses arising from non-payment. When the dealers assigned the installment obligations to the finance companies, the finance companies paid the agreed price to the dealers, which included a percentage the finance companies retained in a "dealer's reserve" to cover the dealer's contingent liabilities. After an appropriate period, the amounts retained, less any amount applied to cover the dealer's actual liabilities under the agreement, were paid over to the dealers.

On these facts, the Court held that the sums in the dealers' reserve were "vested in and belonged to" (*id.* at 463) the dealers and should be accrued in their income at the time of their assignment of the installment obligations. As the Court analyzed the economic realities of the arrangement, the funds in the dealers' reserves were currently taxable to the dealers because they would either ultimately be given to the dealers or applied for their benefit against their contingent obligations to the finance companies. Here, too, the "unearned premiums" on the A&H coverage would either be paid over to the taxpayers or applied against their contingent obligations to the policyholders. Under these circumstances, the *Hansen* principle requires that the taxpayers take the unearned premiums into

account for tax purposes and include them in their "total reserves" under Section 801(c).

b. While the Court of Claims acknowledged in *Penn Security* that its holding would produce "some anomalies" "which can be questioned on economic or actuarial grounds" (Pet. App. 19a), it concluded that the "literal words" of Section 801 compelled the attribution of the A&H reserves to the issuing company under the Treaty I-type arrangement. But as we have demonstrated in Part B, *supra,* pp. 37–41, the language of the statute shows that the accident and health reserves are includable in the taxpayers' "total reserves." [16]

The fundamental error of the Court of Claims' ruling that the A&H reserves were attributable to the issuing company in the Treaty I-type arrangements was to confuse the concept of "unearned premium reserve" with the unearned premiums themselves. While they are equal in amount, they are entirely different items on an insurance company's balance sheet. The unearned premium reserve represents the potential liability to the policyholders and can therefore only be attributed to the company that bears the liability, *viz.,* the reinsurer of the risk. However, the unearned premiums are the amount of premiums collected that are allocable to periods of future coverage.[17]

[16] In Part E, *infra*, pp. 66–75, we discuss whether the other companies with which the taxpayers contracted were required by state law to establish the A&H reserves so as to fit within the statutory category "all other insurance reserves required by law" (Section 801(c)(3)).

[17] In No. 75–1285 (*Penn Security*), the Court of Claims demonstrated that it viewed the premium dollars as the reserves by citing

A company that simply holds "unearned premiums" on behalf of another company until they are "earned" cannot include the equivalent amount in a reserve for "unearned premiums" under Section 801(c)(2) unless it has the ultimate liability to meet policyholder claims.[18] Since Consumer Life was ultimately liable under Treaty I to meet such claims, the "unearned

with approval the statement of Arthur Crooks Eddy (who testified as an expert for the taxpayers in all of these cases) that the liability for an unearned premium reserve "depends on whether you've got the money or not * * *" (Pet. App. 44a). But that would be equally true in the case of a company that makes time deposits with a bank equal to the amount of premiums it receives. In such a case, the bank, to use Mr. Eddy's phrase "has got the money," but it could hardly be contended that the company would not have to maintain the reserve. It should make no difference where, as here, the "bank" is another insurance company.

[18] In support of its holding in *Penn Security*, the Court of Claims (Pet. App. 13a) relied upon Treasury Regulations (26 C.F.R.), Section 1.801–3(e), which defines "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." Focusing upon the advance payment characteristic of "unearned premiums," the court concluded that the taxpayer did not receive "unearned premiums" because under the Treaty I-type arrangement the monthly reinsurance premiums were payable only after they had been earned by the taxpayer. But this reasoning similarly confuses the unearned premiums themselves with the unearned premiums reserves, which is the relevant factor for purposes of the reserve ratio test. Moreover, the court appears to have overlooked the Regulation's reference to the "cost of carrying the insurance risk * * *." Since the taxpayers undertook under the Treaty I-type arrangements to reimburse the issuing company for all claims paid, it can hardly be said that the issuing company bore the "cost of carrying the insurance risk" for any period, much less "the period for which the premiums have been paid in advance."

premiums" are attributable to it for purposes of the Section 801 reserve ratio test.[19]

Like the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*), the dissenting opinion of then Judge Stevens in *Economy Finance Corp.* v. *United States, supra,* 501 F. 2d at 483–486, argued that the A&H premium dollars were

[19] The fact that the Court of Claims concluded that the taxpayers were not required under Georgia, Arizona, or Missouri law to establish a reserve for the A&H policies (see Part E *infra*, pp. 66–75) does not weaken our argument that the economic reality and the statutory language require the inclusion of these reserves under Section 801(c)(2). By explicitly providing that the term "unearned premiums" "includes all unearned premiums, whether or not required by law," Treasury Regulations (26 C.F.R.) Section 1.801–3(e) confirms that Section 801(c)(2) does not turn upon state law requirements.

Indeed, in the life insurance area, this Court has repeatedly held that state insurance statutes or regulatory administrative practices do not control the question whether certain reserves are "life insurance reserves" for federal tax purposes even though they were required under state law. See, *e.g.*, *McCoach* v. *Insurance Co. of North America*, 244 U.S. 585, 589 (reserve for unpaid losses); *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 119 (reserve for unreported losses); *Helvering* v. *Illinois Ins. Co.*, 299 U.S. 88, 90–91 (reserve to meet obligation to provide a tontine fund). As the Seventh Circuit correctly observed in *Economy Finance Corp.* v. *United States, supra*, 501 F. 2d at 478–479, in the context of a Treaty I-type arrangement, "[t]he fact that the state insurance authorities required or permitted [the issuing company] to hold the reserve for solvency purposes does not answer the question of whose business the reserves measure." Likewise, in No. 75–1260 (*First Railroad*), where the taxpayer appears to have conceded the point (A. 125–126), the court of appeals stated with respect to a Treaty II-type arrangement, "[t]he fact that the state insurance authorities permitted the 'reserves' to be handled as done by Insurer and Reinsurer cannot overcome these economic realities" (Pet. App. A 5a, n. 8).

only paid over to the reinsurer after they were "earned" and "only as those premiums were earned, did [the issuing company] use those funds to purchase reinsurance from the taxpayers" (*id.* at 484). However, such an analysis is inconsistent with the undisputed reinsurance aspects of the transaction: there would hardly be any need for the issuing company to reinsure a risk with respect to a period that had already expired. Thus, the substance of the agreement, as the majority there concluded, was that the entire A&H risk was assumed by the reinsurer at the very outset of the arrangement and that the issuing company retained a small commission for administrative services.

Finally, the dissent suggested (*id.* at 486, n. 7) that the government's position "would lead to the disqualification of any company writing nothing but term life insurance." (See also No. 75–1285—Pet. App. 18a). But such a company would undoubtedly receive premiums and establish reserves to meet policyholder claims that would qualify as "life insurance reserves" as that term is defined in Section 801(b). Indeed, while Congress might have regarded term life insurance as different from ordinary life insurance, the Court of Claims has held that it did not do so. See *Alinco Life Insurance Co.* v. *United States, supra.*[20]

[20] The dissent in *Economy Finance* further argued that the reinsurer had not fully assumed the A&H risk because the termination provisions of the treaty only imposed an assumption of 10 percent of the risk (501 F. 2d at 484–485). While we agree with the majority's conclusion in that case that the termination provi-

2. *Treaty II.* Pursuant to Treaty II, the roles of respondent Consumer Life and American Bankers were purportedly reversed. Consumer Life became the primary insurer of the credit life and A&H policies and American Bankers agreed to reinsure 80 percent of the liability under each A&H policy (but none of the life insurance) issued by Consumer Life (Pet. App. B 72a–73a, 99a).

Treaty II provided that Consumer Life would remit quarterly to American Bankers the premiums collected on the ceded 80 percent share of the A&H coverage, less its own tentative "commission" of 50 percent. The agreement further provided that American Bankers would return to Consumer Life a quarterly rebate or "experience refund" equal to the total premiums allocable to the quarter, less the sum of: (1) the 50 percent tentative commission previously retained by Consumer Life, (2) three percent of the gross premiums allocable to the quarter, and (3) all claims paid by American Bankers during the quarter. If the sum of these three reductions exceeded the premiums for any quarter, the excess would be carried over to the succeeding quarter and charged against

sions lacked economic reality because it was unlikely that the reinsurer would assume 10 percent of the risk without any further consideration (*id.* at 478), there was no comparable termination provision in the parallel Treaty I arrangements involved in *Consumer Life* and the Pilot and National Fidelity treaties in *Penn Security*. In these cases, in the event of termination, the treaty would continue to apply to all policies reinsured under the agreement prior to termination (see No. 75–1221—Pet. App. B 117a; No. 75–1285—Pet. App. 42a).

the experience refund for that quarter (Pet. App. B 72a–74a, 120a–121a).

After approximately two years of operation, the parties amended Treaty II to provide that any negative carry-forward arising from loss experience for a particular quarter would be dropped after 20 quarters, if it was not absorbed by that time (Pet. App. A 47a).[21]

Treaty II did not provide for any reinsurance because Consumer Life did not transfer any insurance risk to American Bankers. After issuing the policies, Consumer Life purported to "reinsure" them with American Bankers under an agreement called a "reinsurance treaty." But in addition to Consumer Life's initial retention of 50 percent of the A&H premiums as a commission, American Bankers was required to pay over to Consumer Life 47 percent of the premiums after deduction of claims paid. Thus, Consumer Life bore the entire risk of loss on the A&H business and paid American Bankers a commission that could

[21] Treaty II is essentially identical to the treaty involved in No. 75–1260 (*First Railroad*). There, the agreement provided that Georgia Insurance, the counterpart to American Bankers, would not ultimately bear any losses and would receive neither more nor less than its four percent commission (see Pet. App. A 4a). However, unlike Treaty II, there was no immediate tentative "ceding commission" paid to the direct insurer in *First Railroad*. Moreover, it is unclear whether the direct insurer in *First Railroad* ever actually transferred any funds to Georgia Insurance in excess of its four percent commission. The transfers to Georgia Insurance and its return of the "ceding commission" to Georgia Life appear to have been accomplished by "accrual accounting" (see No. 75–1260—A. 71).

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not exceed three percent for holding the premiums and paying the claims (Pet. App. B 74a).

As was the case under Treaty I, American Bankers functioned as a paymaster or commision agent, not an insurer. For the reason we have set forth in our analysis of Treaty I (*supra*, pp. 52–61), the A&H reserves were therefore attributable to Consumer Life and not to American Bankers.

Indeed, American Bankers' commission was never meaningfully put to any risk. Under the initial version of Treaty II, American Bankers could carry forward any loss in excess of 50 percent of premiums and reduce Consumer Life's "experience refund" for the succeeding quarter. The loss-carry-forward procedure was subsequently limited to losses for more than five consecutive years.

The practical effect of the arrangement was that American Bankers would in all events receive neither more nor less than its three percent commission and would incur no loss unless the claims exceeded 47 percent of premiums for more than five consecutive years. However, the loss experience on A&H policies under the initial version of Treaty II was 18 percent of premiums paid.[22] The trial judge was therefore amply justified in finding that the likelihood that the loss experience would run so high as to jeopardize American Bankers' commission was "so

[22] In No. 75–1260 (*First Railroad*), the claims averaged only about 22 percent of the premiums (Pet. App. A 4a).

remote as to be negligible, and the parties knew this" (Pet. App. A 48a).[23]

In determining tax consequences, the courts are not bound by remote hypothetical contingencies that are at odds with the practical realities and substance underlying a transaction. See, *e.g.*, *Jones* v. *United States*, 531 F. 2d 1343 (C.A. 6); *Kinsey* v. *Commissioner*, 477 F. 2d 1058, 1063 (C.A. 2). "Figures speak and when they do, Courts listen." *United States* v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808, 809 (C.A. 5) (Brown, J., concurring). The figures in these cases eloquently testify to the fact that the Treaty II-type arrangements were an elaborate facade of hypothetical and speculative risk-shifting behind which the so-called "reinsurance company" bore no risk of loss and served in the selfsame paymaster capacity as American Bankers under Treaty I. For all practical purposes, American Bankers had no stake in the A&H business except to the extent of its three percent commission which it received under all foreseeable circumstances.

As the Fifth Circuit succinctly stated in No. 75–1260 (*First Railroad*) with respect to an arrangment identical to Treaty II: "Reinsurer under the arrangement did not bear any risks except the outside possibility of

[23] In No. 75–1260 (*First Railroad*), even the district court, which upheld the taxpayer's position with respect to a Treaty II-type arrangement, conceded that "the risk of loss upon Georgia Insurance was, in actuality, remote" (Pet. App. B 14a).

insolvency of Insurer. We hold therefore there was no substance to the agreement as reinsurance" (footnote omitted) (Pet. App. A 4a–5a). The lack of substance as reinsurance of Treaty II and its counterpart in *First Railroad* demonstrates that neither Consumer Life nor Georgia Life were eligible for "life insurance company" status while those agreements were in force.

E. THE APPLICABLE STATE LAW CONFIRMS THAT THE ACCIDENT AND HEALTH INSURANCE RESERVES ARE INCLUDABLE IN TAXPAYERS' TOTAL RESERVES

While our analysis has proceeded in the first instance upon the language and history of Section 801, it is also confirmed by the applicable state insurance law to which these transactions were subject. Pursuant to these statutes, the taxpayers were required to maintain and establish accident and health reserves under both the Treaty I and II-type arrangements. Thus, the state statutes lend additional support to the proposition that for purposes of Section 801(c)(2), the unearned premiums reserve for non-life coverage must be attributed to the company that bears the risk.

Moreover, this state law is explicitly applicable to the third element of the statutory definition of "total reserves," as set forth in Section 801(c)(3), *i.e.*, "all other insurance reserves required by law." Pursuant to Treaty Regulations (26 C.F.R.), Section 1.801–5 (b), the term "reserves required by law" means "reserves which are required either by express statutory provisions or by rules and regulations of the insurance

department of a State * * *." Thus, if the applicable state insurance statutes required the taxpayers to establish reserves for the A&H coverage on which they bore the ultimate insurance risk, the A&H reserves would also be includable in the taxpayers' "total reserves" as "other insurance reserves required by law" under Section 801(c)(3).

In rejecting the force of the applicable state law in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*), the Court of Claims relied in part upon the fact that neither the Georgia, Arizona, nor Missouri state insurance authorities took any action against the taxpayers' failure to establish such A&H reserves for state reporting purposes (See No. 75–1221—Pet. App. A 86a–91a; No. 75–1285—Pet. App. 21a–22a). But the state insurance officials' failure to require the taxpayers to establish A&H reserves can hardly be dispositive of the question whether these reserves were "required by [state] law" under Section 801(c)(3).

Indeed, in applying substantive federal tax statutes that are based upon state law, as well as in diversity actions, this Court has disregarded the decisions of state trial and even intermediate appellate courts, in the absence of a ruling of the highest court of the state, when it has concluded that the highest court of the state would have decided otherwise. See *Commissioner* v. *Estate of Bosch*, 387 U.S. 456, 464–465; *King* v. *Order of Travelers*, 333 U.S. 153, 160–161; *West* v. *A. T. & T. Co.*, 311 U.S. 223, 227. The error of the Court of Claims' reliance upon the non-action by state

administrative officials follows *a fortiori* from these decisions.

1. There are no decisions of the states' highest courts, or indeed of any state courts, as to whether the taxpayers were required to establish A&H reserves under state law. But any reliance upon the lack of state administrative action against the taxpayers is particularly unjustified in the face of the uncontradicted testimony of the state insurance officials in two of the three cases (*Consumer Life* and *First Railroad*) that their failure to require inclusion of the A&H reserves on the taxpayers' annual statements was a consequence of their unfamiliarity with the substance of the arrangements.

In *Consumer Life,* the Georgia chief insurance examiner testified that Consumer Life's omission of A&H unearned premium reserves from its annual statement was permitted "unwittingly" (A. 239) and was in fact contrary to that state's policy (A. 211–213, 215, 221–226, 232–233, 240, 241–242, 256–259).[24] Similarly, the Arizona examiner who had conducted Consumer Life's triennial examination for that state in 1963 testified that it should have been required to maintain the reserves under Treaty II, but had been

[24] The Georgia official also testified that under Treaty I, Consumer Life should have included the A&H premiums as an asset and established the unearned premium reserve as an offsetting liability to reflect its ultimate obligations under the A&H policies. He further explained that American Bankers should have included the premiums received in its assets as "cash" and included a liability for "[re]insurance premiums owed" (rather than an "unearned premium reserve") (A. 256–258).

permitted to exclude the A&H coverage from its reserves because it was the first time that the Arizona insurance commissioner had encountered that type of arrangement (A. 260, 263–268). Finally, in *First Railroad,* the Georgia examiner testified that the 1967 Georgia insurance examination report, which stated without elaboration that the reinsurance contract appeared to be in good order was "contrary to all reporting standards and practice" (A. 148) and had neither been accepted nor disapproved by the Georgia Department of Insurance (A. 146–149).

2. The foregoing testimony of the state insurance officials in *Consumer Life* and *First Railroad* is confirmed by the language of the relevant state statutes in all three cases.

Arizona, Georgia, and Missouri law are respectively applicable to *Consumer Life, First Railroad* and *Penn Security.* Pursuant to the law of these states, every "insurer" of accident and health policies is required to maintain reserves on all policies in force on a gross unearned premiums basis. See Ariz. Rev. Stat. Ann., § 20–506 (1956) (No. 75–1221—Pet. App. A. 84a); Georgia Code Ann., §§ 56–906 and 56–908 (1935) (No. 75–1221—Pet. App. A. 51a–53a); Ann. Mo. Stat., § 376.410 (1968). An "insurer" is generally defined as an "indemnitor" or person in the business of contracting to indemnify another. See Ariz. Rev. Stat. Ann., §§ 20–103 and 20–104 (1956); Georgia Code Ann., §§ 56–102 and 56–103 (1935).

The significant aspect of these state statutes is that they require the establishment of a reserve by the

company that is ultimately liable to meet policy claims whether or not it has actually received the premiums for the coverage. Thus, under state law, the company whose net worth will be affected by the payment of the claims must reflect that liability on its annual statements by setting up a reserve. Since the taxpayer companies in all three cases either contracted to indemnify the issuing companies or issued the A&H policies themselves, they were the "insurers" of the risks under these state statutes and were required to maintain the A&H reserves.

The existence of the requirement under state law that a company establish a reserve upon its assumption of a risk without regard to its receipt of premiums is demonstrated by the statutory definition of "assets" applicable in these cases. Thus, Ariz. Rev. Stat. Ann., § 20–501(5), (7) and (9) (1956) respectively include in "assets" the following categories (see No. 75–1221—Pet. App. A 53a–54a):

> (5) Premiums in the course of collection other than for life insurance, not more than three months past due, less commissions payable thereon. The foregoing limitation shall not apply to premiums payable directly or indirectly by the United States or by any of its instrumentalities.
>
> (7) Notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, *to the extent of the unearned premium reserves carried thereon.*

> (9) Amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty [emphasis supplied].

Accord: Georgia Code Ann., § 56–901(6), (8) and (10) (1935) (No. 75–1221—Pet. App. A 50a).

These broad statutory definitions of "assets" demonstrate the error of the Court of Claims' statement in *Consumer Life* that the statute requiring the establishment of reserves for the A&H coverage "implies that there were corresponding assets in the first place" (No. 75–1221—Pet. App. A 83a–84a). Paragraph (5) refers to "[p]remiums in the course of collection"; paragraph (7) refers to "notes and like written obligations not past due * * * to the extent of the unearned premium reserves carried thereon"; and paragraph (9) refers to "amounts receivable by an assuming insurer * * * under a reinsurance treaty."[25] These categories of "assets" do not represent premiums paid in hand. Indeed, the reference in paragraph (7)—"to the extent of the unearned premium reserves carried thereon"—proves that the applicable state law contemplates the establishment of the reserve even prior

[25] In *Consumer Life*, the Court of Claims concluded that the Georgia and Arizona definitions of "assets" were limited to "amounts already due and unpaid" (No. 75–1221—Pet. App. B 83a). But paragraph (7) specifically refers to obligations "not past due" taken for premiums, and paragraph (9) speaks of amounts withheld by a ceding insurer "under" a reinsurance treaty. Thus, the language of the statutes themselves refutes the restrictive gloss imposed upon them by the Court of Claims.

to the time when the right to receive the premiums becomes fixed.[26]

Thus, under these prototype state insurance statutes there is no matching principle that a reserve can only be established if there is a corresponding asset. To the contrary, it is the assumed obligation to the policyholder that triggers the requirement of a reserve.[27] But see *Economy Finance Corp.* v. *United States, supra,* 501 F.2d at 485, n. 5 (Stevens, J., dissenting).

a. *Treaty I-type arrangements.* The Treaty I-type arrangement was employed in *Consumer Life* and *Penn Security.* As we have pointed out *supra,* under Arizona law, which is applicable to Consumer Life, an insurance company that assumes the risk under non-life coverage is an "insurer" and is required to establish a reserve, even prior to its actual receipt of the premiums. Since Consumer Life reinsured the risk of the A&H coverage under Treaty I, it was required to establish a reserve corresponding to that risk.

[26] Indeed, Arthur Crooks Eddy, taxpayers' expert witness in *Consumer Life*, acknowledged under questioning by the trial judge that the critical reason for the establishment of the reserve is the responsibility to pay the claims "[i]rrespective of how the premiums are handled and whose [*sic*] holding them" (No. 75–1221—A. 130).

[27] For the generally accepted insurance accounting treatment under the Treaty I-type arrangement, see Hammond, *supra, Insurance Accounting Fire and Casualty*, pp. 142–143. That text states that the assuming reinsurer (the taxpayers) must account for the reinsurance transaction exactly as if it had actually received the premiums from the ceding company. The only difference is that the reinsurer adds the premiums to an asset account entitled "Funds Held By or Deposited With Ceding Reinsurers", instead of to its cash account. See p. 13, n. 4, *supra.*

The Missouri statutes applicable in *Penn Security* are to the same effect. Ann. Mo. Stat., § 376.410 (1968), requires that all companies engaged in writing accident and health insurance "shall maintain reserves thereon" and paragraph (4) provides that "proper credit shall be allowed for reinsurance in other companies licensed to do business in this state." The clear import of this statute is that under a bona fide reinsurance agreement, such as in *Penn Security,* Missouri law permits the ceding company to reduce its reserves and requires the reinsurer to increase its reserves in an amount corresponding to the reinsured coverage.[28] Since *Penn Security* reinsured the risk, it was likewise required to establish a reserve.

b. *The Treaty II-type arrangement.* The Treaty II arrangements are involved in both *Consumer Life* and *First Railroad,* with respect to which Arizona

[28] In rejecting the argument that the Missouri statutes required the inclusion of the A&H reserves in the taxpayer's reserves, the Court of Claims relied upon the inaction of the Missouri administrators and the testimony of the taxpayer's expert witness, Arthur Crooks Eddy, that "no state regulatory authority would impose an unearned premiums reserve requirement where * * * such company did not receive premiums for insurance to be provided in the future" ((No. 75–1221) Pet. App. 48a–49a; see also A. 236; (No. 75–1285) Pet. App. 21a–22a and n. 4). However, the witness failed to consider Ann. Mo. Stat. § 375.246 (1968), which provides that no reduction from reserves is to be allowed "under which the assuming insurer bears no substantial insurance risk or substantial risk of net loss to itself." It is therefore plain that the Missouri statute imposes a reserve requirement on the issuing company where, as in Treaty II-type arrangements, the "reinsurer" does not assume the insurance risk and the issuing company does not receive the premiums until after they are earned.

and Georgia law are applicable. Under the statutes of those states, the ceding company under a reinsurance arrangement is entitled to reduce its reserves when it has reinsured risks with another qualified company. See, *e.g.*, Georgia Code Ann., §§ 56–413 and 56–906 (1935); and Ariz. Rev. Stat. Ann., §§ 20–261 and 20–506 (1956). But the reduction of reserves by the issuing company contemplated by these statutes is for bona fide reinsurance contracts and not for the elaborate Treaty II-type arrangements under which the so-called "reinsurer" bore no risk at all.[29]

Indeed, when an insurance company cedes insurance to a company that is not licensed to do business in the state, a transaction that is a relatively common occurrence, the state will not permit the ceding company to reduce its reserves. From the standpoint of the state authorities, no transfer of risk has occurred. See, *e.g.*, Ariz. Rev. Stat. Ann., § 20–261 (1956), and Georgia Code Ann., § 56–413(3) (1935). It would follow *a fortiori* that the ceding company could not reduce its reserves in a Treaty II-type arrangement, where no risk is in fact transferred.[30]

In sum, the state statutes must be viewed against the background of the settled definition of "reinsurance," as provided by the National Association of Insurance Commissioners in its *Examiners Handbook, supra,* which the state examiners generally follow as a guide in performing their audit functions (see 75–1221–A. 193). The Handbook states (p. B6, No. 75–1260, A. 211):

> The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. *Unless the so-called reinsurance contract contains this essential element, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer* [emphasis supplied].

Since the taxpayers under the Treaty II-type arrangements were the issuing companies and could not reduce their reserves by the A&H coverage they wrote because they did not part with the risk, the applicable state law is in accord with the general rule that we urge in these cases, *viz.*, that the insurance reserves follow the insurance risk.

---

[29] See also Ann., Mo. Stat. § 375.246 (1968), described at p. 73, n. 28, *supra*, which specifically forbids the issuing company to reduce its reserves in a Treaty II-type arrangement.

[30] Even if the Treaty II-type arrangements actually had shifted a significant insurance risk to the reinsurers with respect to claims in excess of ceded premiums, the taxpayers would not be entitled to reduce their own unearned premium reserves. Under such "excess loss" or "stop loss" agreements, pursuant to which reinsurer assumes the risk of such losses beyond a stated portion of gross premiums (rather than a quota share of all losses), the ceding company must continue to retain the reserve for unearned premiums because it bears the ultimate impact of claims to the extent of such unearned premiums. See Reinarz, *Property and Liability Reinsurance Management* (1969 ed.) pp. 72–73, 81.

CONCLUSION

For the reasons stated, the judgments of the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*) should be reversed and the judgment of the court of appeals in No. 75–1260 (*First Railroad*) should be affirmed.

Respectfully submitted.

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AUGUST 1976.

U.S. GOVERNMENT PRINTING OFFICE: 1976

Supreme Court U. S.
FILED
OCT 13 1976
MICHAEL RODAK, JR., CLERK

IN THE

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OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA, Petitioner

v.

CONSUMER LIFE INSURANCE COMPANY, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR CONSUMER LIFE INSURANCE COMPANY, Respondent

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IN THE

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR CONSUMER LIFE INSURANCE COMPANY, Respondent

QUESTION PRESENTED

The question presented is whether unearned premium reserves on accident and health insurance policies which were held by an unrelated insurance company subject to the terms of valid, customary reinsurance agreements, and which were not included in respondent's reserves pursuant to applicable state law, may be attributed to respondent for the purpose of determining whether respondent qualifies as a "life insurance company" for Federal income taxation.

STATEMENT OF THE CASE

The statement of facts set forth in the Government's Brief does not adequately state the case in accord with the extensive findings of fact of the court below. Accordingly, respondent sets forth herein supplemental statements of facts based on the findings and the evidence adduced below.

From the time of its formation, Southern Discount Company ("Southern Discount"), the parent company of respondent, has been engaged in the business of consumer finance and has not been permitted by law to write insurance; respondent was therefore organized as a separate subsidiary to function as an insurance company. At the time respondent was organized, Southern Discount intended that respondent act as a reinsurer until it could qualify to write insurance directly in the states in which Southern Discount conducted business (Finding of Fact 19, App. B, Petition for Writ of Certiorari 98a (hereinafter cited as Pet. App.)). Since Arizona required smaller capital and surplus for the formation of life insurance companies than the states in which Southern Discount engaged in business, respondent was incorporated in Arizona so that it could

engage in the reinsurance business without establishing the larger capital and capital surplus that would have been necessary to be incorporated or to write insurance directly in Georgia and in the other states in question. Southern Discount was thereby enabled to employ its cash in the consumer finance business rather than in the capital of the insurance company.

Prior to the formation of respondent, Southern Discount had acted as agent for the sale of credit life and credit accident and health insurance to its borrowers and received an agent's commission on such sales; this credit insurance was written by various insurance companies (Finding of Fact 10, Pet. App. 95a). However, the commissions which Southern Discount was permitted to charge as agent were limited by law in Georgia and in other states in which it did business (Finding of Fact 12, Pet. App. 95a). Southern Discount determined for valid business reasons to enter the insurance business in order to participate to a greater degree in the profitability of the credit insurance market generated by its consumer loan business (Finding of Fact 12, Pet. App. 95a).

During the taxable years in issue, respondent was a party to two reinsurance treaties with American Bankers Life Insurance Company ("American Bankers"), an insurance company unrelated to respondent, engaged in the life and disability insurance business and organized under the laws of the State of Florida (Finding of Fact 16, Pet. App. 97a). Pursuant to the first reinsurance treaty ("Treaty I") between respondent and American Bankers dated June 19, 1957, respondent reinsured insurance written by American Bankers for customers of Southern Discount. After respondent had accumulated sufficient capital and surplus so that it

could engage directly in the writing of insurance itself, a second reinsurance treaty was entered into in 1962 ("Treaty II"), whereby American Bankers reinsured a portion of the accident and health insurance written directly by respondent. Both of these reinsurance treaties were entered into by respondent for valid business reasons and were transactions between parties dealing at arm's length (Findings of Fact 20, 21, 25 and 26, Pet. App. 98a-99a, 100a).

Reinsurance is a transaction pursuant to which an insurance company which writes insurance *transfers* for a period of time the responsibility for all or a portion of the claims that may arise under policies of insurance (Finding of Fact 18, Pet. App. 97a). This *shifting of responsibility* serves the purpose of spreading out fluctuations in exposure from claims, and the writing (or ceding) company pays the reinsurer consideration for assuming this exposure. Even if the claims experience is ultimately reflected in the cost of the reinsurance, the writing company is able to spread its liabilities or risks over a longer period of time (A. 123). The result of the reinsurance treaties with American Bankers was that respondent was not required by any applicable state laws to maintain reserves for the accident and health insurance to the extent that the accident and health insurance was reinsured pursuant to the treaties (Findings of Fact 18 and 38, Pet. App. 97a, 105a; A. 123).

In its Statement, the Government stated that "respondent therefore freely conceded in the court below (A. 130-133), that under the Treaty I arrangement, it assumed the entire insurance risk on both the credit life and the credit accident and health policies" (Brief for Petitioner at 8 (hereinafter referred to as Pet. Brief)).

The Government is in error in this regard. Respondent made no such concession in the court below, and respondent strenuously objects to such statement. The Treaty itself and the findings of the court below are clearly to the contrary and speak for themselves. The Court of Claims found that under Treaty I, "Plaintiff's obligation to reimburse American Bankers for insurance claims incurred was limited in the aggregate to the amount it received from American Bankers according to the treaty" (Finding of Fact 39, Pet. App. 105a). As to Treaty II, the court found that American Bankers' obligation to reimburse respondent for insurance claims incurred was not limited in any way (Findings of Fact 41 and 46, Pet. App. 106a, 108a).

There is no Federal insurance code affecting the industry generally. The insurance industry is regulated by the states; insurance companies are required to submit annual statements to the various state insurance commissions on a standard form developed by the National Association of Insurance Commissioners which provides information generally as to the amount of business in force, premiums received, commissions paid, the nature and amount of reserves maintained and claims experienced (Finding of Fact 49, Pet. App. 109a). Approximately every three years, an insurance company is investigated and examined by examiners employed by or working under contract to the insurance commissions of some or all of the states in which the company does business, for the purpose of ascertaining whether a company is conducting its business in compliance with state laws, regulations and procedures established primarily for the benefit of policyholders (Findings of Fact 48 and 50, Pet. App. 108a). Respondent was the subject of such examinations in 1959 and 1963, conducted by

insurance examiners from the State of Arizona (Finding of Fact 52, Pet. App. 109a). Similarly, American Bankers was the subject of a triennial examination in 1960 by the Insurance Departments of Florida, Arizona, Georgia and other states in which it conducted business (Finding of Fact 53, Pet. App. 110a).

Respondent did not establish unearned premium reserves with respect to the reinsurance of the American Bankers accident and health insurance policies under Treaty I nor with respect to the accident and health insurance ceded by respondent to American Bankers under Treaty II, nor was it required to establish such reserves by any state regulatory agency pursuant to the triennial examination or otherwise (Findings of Fact 40 and 42, Pet. App. 106a). Furthermore, the treatment of these reserves by respondent was proper from actuarial and accounting standpoints (Finding of Fact 47, Pet. App. 108a). Had respondent been required to maintain full reserves in the amount of 100% of the unearned premiums, its earnings and the consolidated earnings of Southern Discount would have been substantially reduced, with the result that Southern Discount's borrowing power would have been diminished, which would have adversely affected Southern Discount's primary business of lending (Finding of Fact 25, Pet. App. 100a). No existing state law had the effect of "attributing" to respondent any of the unearned premium reserves held by American Bankers on the insurance which was the subject of Treaties I and II (Finding of Fact 44, Pet. App. 107a).

The unearned premiums and corresponding reserves in question under Treaties I and II were both actually held by American Bankers, which received the investment income thereon, and reported by American Bankers for purposes of state regulation as well as taxation. No state regulatory agency required American Bankers, pursuant to the triennial examination or otherwise, to report the unearned premium reserves in any different fashion. Respondent did not obtain or use the unearned premiums reflected in the annual statements of American Bankers, nor were any of the said unearned premiums credited, set apart, or made available to respondent (Finding of Fact 43, Pet. App. 107a).

The Government in its Statement has referred to the testimony of its witnesses from the insurance departments of the States of Georgia and Arizona, respectively (Pet. Brief 13). Said references, it is submitted, are entirely misleading. The testimony of both of these witnesses was discredited,[1] and the court below, after con-

[1] Mr. Sturtevant testified that his background was that of an actuary for an insurance company and there was no testimony with respect to his qualifications concerning his expert status in matters relating to accounting or reinsurance of the type in issue in this case. Mr. Sturtevant testified that he completed his education in 1917 and he offered no further evidence of education or expertise with respect to matters relating to accounting for insurance companies since that date. He further testified that prior to 1960, at which time he became a special consultant following his retirement, he had no familiarity with credit life insurance (A. 236), he had never read a credit accident and health contract (A. 237), he had no personal experience with either a credit life or a credit accident and health contract (A. 237), and he had never read a reinsurance agreement dealing with credit life insurance or credit accident and health insurance (A. 237). Furthermore, he testified that prior to this case, he had never read reinsurance treaties such as the ones in issue in this case and that this was his first exposure to policies of insurance of the type in issue in this case (A. 259). He further testified that this was the first time he had ever had an opportunity to form an opinion as to the accounting and reserve treatment with respect to such policies and that this was the first time that he had ever applied accounting principles to this particular type of situation. Mr. Sturtevant stated that he had never examined such a contract until he was presented a copy of Treaty II at the time of his appearance in court in connection with this case (A. 260).

Mr. Tom Robinson, an examiner for the State of Arizona De-

sidering the testimony, rejected it in reaching its Findings of Fact.[2]

SUMMARY OF ARGUMENT

I.

Congress has devised a simple test by which an insurance company may determine whether it is a life insurance company and therefore in what fashion it will be required to pay income taxes. This test has remained virtually unchanged since the statute was enacted in 1921, and is currently located in Section 801(a) of the

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partment of Insurance, testified that Treaty II, in his opinion, was a surplus aid contract. Mr. Robinson further testified that he presented his position to the Director of Insurance for the Department of Insurance of Arizona in person and that he analyzed Treaty II in his presence (A. 266). Mr. Robinson's further testimony on cross-examination was that "so far as my efforts in respect to these contracts, it was almost an effort in futility. . . . Well, so far as I know, no result ever came from it" (A. 272). Thus, the Arizona Department of Insurance was not in agreement with the opinions of Mr. Robinson notwithstanding the fact that Mr. Robinson discussed the question carefully and in person with the head of the Arizona Insurance Department. Mr. Robinson further stated that at a later time he became the Assistant and Acting Director, and still did not take action with respect to this matter. Mr. Robinson testified clearly that the Department of Insurance of the State of Arizona examined both respondent and American Bankers, and that the examination would have included a careful analysis of the reinsurance treaties, and the State of Arizona did not require respondent to establish reserves on the accident and health reinsurance that was the subject of Treaty II.

[2] With respect to its conclusion that Georgia law did not require respondent to maintain the reserves in question, the Court of Claims stated:

> Finally, with relation to the testimony of Mr. Sturtevant, who testified that the unearned premium reserve as reported by American Bankers and Plaintiff was permitted 'unwittingly' by the Georgia Insurance authorities, we have reviewed his testimony and it does not change our interpretation of the Georgia law above expressed [Pet. App. 91a].

Internal Revenue Code of 1954. If an insurance company holds life insurance reserves in an amount which constitutes more than fifty percent of the total reserves which it holds, the company qualifies as a life insurance company and is taxed accordingly.

In the present case there is no dispute as to the amount of life insurance reserves held and reported by respondent. The question in this case is whether, as the Commissioner of Internal Revenue claimed, the total reserves held by respondent should have included certain unearned premium reserves on accident and health insurance which were not held by respondent, but in fact were held and reported by American Bankers, an unrelated life insurance company with which respondent had entered into certain reinsurance treaties. The Court of Claims held that said reserves could not be attributed to respondent and that respondent therefore qualified as a life insurance company.

The Commissioner did not attempt to attribute the unearned premium reserves to respondent by virtue of sections 269 or 482 of the Internal Revenue Code, which by their terms specifically provide for attribution or reallocation of certain funds among related parties, since the prerequisites for application of those sections of the Code did not exist in respondent's case. The Commissioner claimed, rather, and the Government contends in this appeal, that respondent remained liable on the risks to which the accident and health insurance in question pertained, and therefore should have established the reserves therefor, or at least that those reserves should be attributed to respondent. This contention is made in spite of the fact that the statute in question makes no reference whatsoever to risk as a

test for qualification, and the legislative history of the statute and its forerunners, as well as the courts which have considered the question, confirm the fact that the reserve requirements for insurance companies are to be established by the states and not indirectly through its taxing power by the Federal government. The states which had authority over the conduct of respondent's business regularly examined that business and specifically the sufficiency of the reserves maintained therefor, and on more than one occasion approved the arrangements now brought into question.

A misinterpretation of the distinctions between insurance risk and the risk of not making a profit has led the Government to state that respondent conceded that it bore the ultimate insurance risk on the policies in question. In fact, respondent shared, to the extent of premiums received by respondent, the expense of the claims under the accident and health insurance and could have conceivably been prevented from realizing any profit thereon. Respondent's liability, however, was limited under the treaties at issue in this case to the premiums paid, and could never have exceeded those premiums nor resulted in an economic loss to respondent, since American Bankers bore the true insurance risk in each case and was subject to no limitations. Regardless of who bore the risk (and perhaps in fact, as this case illustrates, because of the difficulty of determining in any case who does bear the risk, or a given share thereof) no statute or regulation exists which suggests that incidence of risk determines the attribution of reserves for purposes of life insurance company qualification. The Government's theory is unsupportable and without any authoritative precedent. To attempt

to impose such a test upon an industry where reinsurance is the norm and most risks are shared to some degree among companies would result in chaos. Indeed the Commissioner's own regulations, in an effort to provide certainty in this field, require that before a reserve may be claimed by or charged against a party, that reserve must be both actually held by it and reported on its annual statements. The Government has not, in the entire history of this case, suggested any reason why the Commissioner must not be held to the requirements of his own regulations on this matter.

II.

Respondent was formed, and entered into the business of credit insurance, in an effort to increase the profitability of its parent company's consumer finance business through providing insurance to its parent's borrowers. Respondent was formed in a state which required lower capital and surplus for insurance companies than most other states, and earned sufficient income through its initial business of reinsurance (which did not require qualification in other states) and accumulated enough capital to qualify to write insurance directly in the states in which its parent company conducted business.

Respondent's insurance business, both as a reinsurer and later as the writing company, was composed of both life insurance and accident and health insurance. The reserves required for this insurance were maintained by either respondent or American Bankers, the other party to respondent's reinsurance treaties, in accordance with the requirements of the state insurance authorities and the terms of those treaties. The reserves required as to accident and health insurance tradition-

ally consist of the entire unearned premium paid for said insurance, and those reserves diminish as the premiums become earned. Initially, those reserves constitute a substantial economic burden, and respondent contracted in both reinsurance treaties for American Bankers to maintain those reserves. American Bankers was a much larger company and was able to absorb the accident and health reserves without unduly restricting its financial condition. Also, because of this reinsurance arrangement, respondent qualified as a life insurance company for purposes of Federal income taxation.

The arrangements between respondent and American Bankers were reached as a result of arms length bargaining between unrelated parties. The reinsurance treaties were entered into for substantial non-tax as well as tax purposes, and they resulted in appreciable non-tax consequences. They were carefully reviewed by the state authorities who regulate the insurance industry, and no suggestion was made, either to respondent or American Bankers, that the maintenance of unearned premium reserves by American Bankers was improper or unlawful.

The insurance treaties, and maintenance of reserves thereby required, were lawful and proper. These business arrangements are entitled to recognition for Federal income tax purposes to the same extent that they were recognized and approved for non-tax purposes.

ARGUMENT

I. UNEARNED PREMIUM RESERVES ESTABLISHED BY AN UNRELATED INSURANCE COMPANY IN ACCORDANCE WITH APPLICABLE STATE LAW AND INSURANCE INDUSTRY ACCOUNTING AND ACTUARIAL PRACTICES MAY NOT BE ATTRIBUTED TO RESPONDENT'S "TOTAL RESERVES" FOR PURPOSES OF DETERMINING WHETHER RESPONDENT QUALIFIES AS A "LIFE INSURANCE COMPANY."

A. Respondent Qualifies as a Life Insurance Company Based upon the Express Statutory Test of Section 801 of the Internal Revenue Code of 1954.

The present statutory scheme for the Federal income taxation of insurance companies divides insurance companies into three basic groups. The first group consists of life insurance companies taxable pursuant to section 802 of the Code; the second group consists of mutual insurance companies (other than life insurance companies) taxable pursuant to section 821 of the Code; and the third group consists of insurance companies (other than life or mutual companies) taxable pursuant to section 831 of the Code. The ultimate question in the instant case is whether respondent is to be taxed as a life insurance company in accord with section 802 or as an insurance company other than a life company pursuant to section 831.

The definition of a life insurance company is set forth in section 801 of the Code, which provides a test measured in terms of life insurance reserves. That test requires that at least fifty percent of the total insurance reserves which a company holds must consist of life insurance reserves. Section 801(a) provides:

> [T]he term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) . . . if
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

Life insurance reserves as defined by Section 801(b) are amounts which are computed or estimated on the basis of recognized mortality tables and assumed rates of interest and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance and annuity contracts and certain noncancellable health and accident insurance contracts; and, in addition, reserves must be required by law except in certain circumstances not pertinent here.

The term "total reserves" is defined in Section 801(c) as meaning:

> (1) life insurance reserves,
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and
>
> (3) all other insurance reserves required by law.

The issue presented in this case is whether the unearned premium reserves held by American Bankers with respect to the accident and health policies in question are includible in respondent's "total reserves" (as defined in section 801(c)) for purposes of the reserve

ratio test prescribed by section 801(a). It is respondent's position that the unearned premium reserves established and held by American Bankers, a company which was unrelated to respondent, are not includible in respondent's total reserves for the purposes of the reserve ratio test. Respondent submits that the reserves in question are not "attributable" to respondent as the Government maintains and, therefore, respondent should qualify as a life insurance company as that term is defined in section 801(a) of the Code. The Government's position appears to be that "a company's eligibility for life insurance company status necessarily turns on whether it in fact assumes life insurance risks" (Pet. Brief 45), and "that the reserves must be attributed to the company that actually assumes the insurance risk" (Pet. Brief 48).[3] Respondent respectfully disagrees with these assertions in that such tests are clearly contrary to the express language of section 801 and the legislative intent thereof and seek to measure life insurance company status by a vague Federally imposed yardstick for determining reserves which, in itself, is contrary to the clearly expressed Congressional intent that state law will control in matters relating to insurance companies.

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[3] The Government has cited *Helvering v. LeGierse*, 312 U.S. 531 (1941) as authority for the proposition that the essence of insurance is risk-shifting. Such a statement was indeed made in that case. The case, however, dealt with the question of whether insurance proceeds were to be included in a decedent's gross estate. It is submitted that this case constitutes no precedent for any issue now before the Court.

The reserve ratio test has been expressed by the Court of Claims in *Alinco Life Ins. Co. v. United States*, 373 F.2d 336, 350 (Ct. Cl. 1967) in terms of the following table:

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on noncancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

The first attempt at defining a life insurance company for the purposes of Federal income tax laws occurred in the Revenue Act of 1921 which first accorded special tax status to life insurance companies. Section 242 of that Act defined a life insurance company as one which is:

> engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

While the statutory definition was modified somewhat in the Revenue Act of 1942, the reserve ratio test was preserved for purposes of defining a "life insurance company." [4] The present reserve ratio test of section 801(a) of the Internal Revenue Code of 1954 is essentially the same as that originally enacted in 1942 as section 201(a) of the 1939 Code.[5] Thus, the reserve ratio test as originally enacted in 1921 and modified in 1942 has been based throughout this entire period upon a ratio of life insurance reserves compared with "total reserve funds" and since 1921 that ratio has continued to be fifty percent for the purposes of the qualification formula.

The question of what constitutes "reserve funds" has been the subject of substantial attention over the years. Several early cases considered the question of the meaning of the term "reserve funds required by law" [6] in the context of whether such reserves were deductible in determining the net income of the insurance companies involved. These cases generally held that such reserve funds had a technical meaning in the tax law and did not, for instance, include amounts held against unpaid losses, and that "the term reserve funds has

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[4] The 1942 Act, however, did go further to define total reserves as meaning "life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law." Int. Rev. Code of 1939, §201(a).

[5] Senate Report No. 291 of the Senate Finance Committee on the Life Insurance Company Income Tax Act of 1959, 1959 U. S. Code Cong. & Ad. News 1575, 1616.

[6] Section 12(a) of the Revenue Act of 1916, 39 Stat. 756, permitted deductions from gross income of, "in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds. . . ." Thus, these cases deal principally with the question of deductions from income.

reference 'to the funds ordinarily held as against the contingent liability on outstanding policies.' " *McCoach v. Ins. Co. of North America*, 244 U.S. 585, 589 (1917); *see also Ocean Accident and Guarantee Corp. v. Commissioner*, 47 F.2d 582, 584 (2d Cir. 1931) and cases cited therein. The Internal Revenue Service ruled under the Revenue Acts of 1913 and 1918 that reserve funds required by law included not only reserves required by express statutory provisions but also included reserves required by the rules and regulations of the state insurance departments. L.O. 1104, I-II Cum. Bull. 331 (1918).

In discussing the derivation of the term "reserve fund" as used in the various Revenue Acts, one authority on Federal income taxation states:

> It was not clear whether the term "reserve fund" as used meant assets held to provide for a liability or whether it meant the stated liability itself without regard to whether the company has reserved sufficient assets to provide for it. The term "fund" as used by laymen generally signifies money or the equivalent—hence assets. But actuaries use the terms "reserve" and "reserve fund" synonymously and frequently to express not money or the equivalent but a liability for which money is needed. And the provisions of the Code which deal with life insurance companies were drafted by and with the assistance of actuaries for taxpayers who are accustomed to actuarial language. . . .
>
> The term "reserve fund" appears to have been derived from the term "fund" used in the schedules of the Life Assurance Companies Act of 1870, and the Assurance Companies Act of 1909, acts passed by the English Parliament for the control of insurance companies, where the term "fund" was used to express the company's reserve liability

> under its policies which it was required to report on the liability side of the schedules. . . .
>
> * * *
>
> The question of whether the term "reserve fund" as used meant a liability or meant assets held for a liability was sometimes of importance, e.g., Pilot Life Ins. Co., 9 BTA 980, where a reserve deduction was allowed only to the extent of the assets held and not to the extent of the full liability. . . . 8 Mertens *Law of Federal Income Taxation* §44.26, n. 1 at 73 (1970).

The Government asserts that the fundamental error committed by the court below was that it confused the concept of "unearned premium reserves" with the unearned premiums themselves (Pet. Brief 16). "Unearned premiums" are defined in the regulations as those amounts which cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Treas. Reg. § 1.801-3(e). The regulations further provide that unearned premiums "must have been actually held during the taxable year." Treas. Reg. §1.801-4(a). Contrary to the Government's assertion of fundamental error, respondent finds no confusion between unearned premiums, on the one hand, and unearned premium reserves, on the other, in the court's conclusions. The court below, throughout its findings, recognized the preciseness of the terminology involved. For example, the court found that the unearned premium reserve for accident and health insurance is 100% of the gross premium at the outset of the policy term, (Finding of Fact 36, Pet. App. 104a); and that the unearned portion of the premium "is set aside on the books and records of the Company as the unearned premium reserve" (Finding of Fact 32, Pet. App. 103).

The court further recognized that as the policy expires with the passage of time, the premium becomes "earned" to the extent of the expiration, because the earned portion was paid for coverage which had been provided during the expired portion of the policy. *Id.* Thus the Court of Claims concluded that an unearned premium reserve measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of said premiums that represent payment for insurance to be provided after the reserve valuation date (Finding of Fact 33, Pet. App. 103a). The court also made findings to the effect that the unearned premiums in this case were physically held by American Bankers (Finding of Fact 43, Pet. App. 107a). Based on the foregoing findings by the court below, respondent submits that the Government's contention is erroneous, and that the court used the term in the correct technical sense relying on the evidence adduced at trial.

Furthermore, in the present case the applicable state law and accounting practice in the insurance industry demonstrate that there is no reason to distinguish between unearned premiums and unearned premium reserves. Both the Arizona and Georgia insurance laws set forth reserve requirements for casualty insurance in terms of unearned premiums. Ariz. Rev. Stat. Ann. §20-506; Ga. Code Ann. §56-906. Also, it is standard in insurance accounting that the company which possesses the unearned premiums is the only company required to maintain the reserves thereon (Finding of Fact 47, Pet. App. 108a; A. 118-19). For accounting purposes it seems clear that the party which holds the unearned premiums must establish the reserves since, as a matter

of accounting, the "asset" which consists of premiums received must be offset by a "liability," which could be either reserves or surplus. Where there are no assets, there can similarly be no offsetting reserves or surplus without adjusting some other liability account. In the present situation, respondent had no guarantee that it would receive any amounts from American Bankers, and whenever they were received, they would no longer be "unearned" in the respondent's hands. Therefore it would have been improper for respondent to have established an unearned premium reserve for unearned premiums which it did not hold nor had any right to receive, and could not therefore have claimed as an asset. It is proper, therefore, for the party with the asset to establish the liability. That Congress used the phrase "unearned premiums" establishes that Congress was aware of prevailing state law and insurance industry accounting practices in this regard and that said term is used in its technical sense.

B. State Law is Centrally and Expressly Involved in the Definition of a Life Insurance Company for Purposes of the Internal Revenue Code.

Insurance companies have always looked to the laws of the various states in which they are engaged in business for rules and regulations as to the types and amounts of reserves required for their business purposes (Finding of Fact 48, Pet. App. 108a). The states have long exercised regulatory control over the insurance industry because of the obvious public interest in maintaining solvent insurers. Congress, rather than attempt to impose Federal standards for the definition of reserves in the Federal income tax laws, has consistently

left the establishment of said standards to the various states.

In recognition of this Congressional intent, decisions of this Court confirm the central and express importance of state law requirements relating to "reserves" or "reserve funds" as those terms are used for Federal income tax purposes with regard to insurance companies, both life and non-life. In *Brown v. Helvering*, 291 U.S. 193, 201 (1934), this Court stated:

> [T]he deductions allowed for additions to the reserves of insurance companies are technical in character and are specifically provided for in the Revenue Acts. These technical reserves are required to be made by the insurance laws of several states.

The importance of state law requirements with regard to the qualification of reserves as "life insurance reserves" under the reserve-ratio test has been illustrated in more recent cases such as *Mutual Benefit Life Ins. Co. v. Commissioner*, 488 F.2d 1101, 1105-06 (3rd Cir. 1974); *Drummond Citizens Ins. Co. v. United States*, 298 F. Supp. 692, 697-98 (E.D. Ark. 1969), *aff'd*, 427 F.2d 1163 (8th Cir. 1970); and *Lamana-Panno-Fallo Industrial Ins. Co. v. Commissioner*, 127 F.2d 56 (5th Cir. 1942).

This Congressional intent to rely upon state law for the substantive regulation of the insurance industry is the keystone of insurance company taxation, and provides an element of certainty upon which companies may rely in determining their tax liabilities. As stated in Denny, Rua and Schoen, *Federal Income Taxation of Insurance Companies* (2d ed. 1966) at 5-9,

> Congress has left to the states the determination of the amounts which must be reserved by insurance companies to provide for their liability to policyholders under the various types of contracts written.

During the hearings in connection with the Life Insurance Company Income Tax Act of 1959, Representative Curtis of Missouri said:

> I think we can easily write a tax code if we determine that we are going to regulate the industry at the Federal level. I have resisted that to date because I do not think it is to the good of our society . . . . Committee Print of Hearings Held November 17-20, 1958, Before Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, U.S. House of Representatives, 85th Cong., 2d Sess., 1958.

The propriety of the Government's use of Section 801 as a means of regulating the insurance industry at the Federal level was discussed in great detail by the Court of Claims in its decision in *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Ct. Cl. 1967). The court there stated:

> The Government's presentation of its case against Alinco has been flavored with moral and regulatory overtones. Such a sensitive concern for good business morals should not be for the Treasury. . . .
>
> Insofar as regulation is concerned, it is of course true that Congress frequently employs a taxing statute to achieve a non-fiscal or regulatory goal. Where, however, there is a Congressional intent to connect a regulatory objective to a revenue raising measure, the legislative history will always disclose that intent either directly or indirectly. See *United States v. Kahriger*, 345 U.S. 22, 27 (1953).

The Congressional intent is obvious from an examination of the Code itself. Subsections (b) and (c) of section 801, in defining life insurance reserves and total reserves, refer explicitly to reserves "required by law" unless specifically excepted. The exceptions have no bearing on this case, but the need for their existence is further illustration of the reliance of the Code upon state law requirements.[7] That the law referred to is state law is clear from the absence of Federal law as to requirements for insurance reserves and the explanation in the Treasury Regulations that the laws in question are those of the States, Territories and District of Columbia, and any lawful regulations issued pursuant thereto. Treas. Regs. §§1.801-4(a) and 1.801-5(a). The reason for such reference to and reliance upon reserves required by law is apparently to eliminate the possibility of manipulation of reserves, upon which not only qualification but the amount of tax is based (since reserves constitute an offset against income pursuant to sections 809 and 810 of the Code), while permitting arrangements for valid business purposes which satisfy the comprehensive state requirements.

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[7] The importance of state law to the scheme of taxation of life insurance companies is also clear from the many references thereto in the Code and Treasury Regulations. The legislative history concerning the exclusion of deficiency reserves from life insurance reserves for purposes of the reserve ratio test illustrates the central importance of state law requirements to the definition of a life insurance company. In discussing the statutory language which excluded deficiency reserves for these purposes, the Senate Report accompanying the Life Insurance Company Income Tax Act of 1959 stated that "the effect of this language . . . is to exclude deficiency reserves both from life insurance reserves and total reserves, *even though such deficiency reserves are required by State law.*" Senate Report No. 291, 1959 U.S. Code Cong. & Ad. News 1575, 1617. (emphasis added).

C. The Respondent Was Not Required by Applicable State Law to Maintain the Unearned Premium Reserves on the Accident and Health Policies Subject to the Reinsurance Treaties in Question.

Pursuant to the terms of respondent's initial contract with American Bankers ("Treaty I"), American Bankers ceded to respondent all of the credit life and credit accident and health insurance which it wrote on the customers of Southern Discount. The liabilities of respondent pursuant to the terms of Treaty I "followed" the liabilities of American Bankers, except that the liability of respondent as to the credit accident and health insurance was on an "as earned" basis whereas the liability of respondent as to the credit life insurance was on an "as written" basis.[8] The effect of this difference in the type of reinsurance provided was that respondent received the entire premium on the credit life insurance as that insurance was written by American Bankers, and respondent was obligated to reimburse American Bankers for all credit life insurance claims paid by American Bankers during the course of the treaty. There was no limitation to respondent's liability as to said credit life insurance. As to the credit accident and health insurance, however, respondent received premiums from American Bankers only as they became "earned" each month. Under the terms of the treaty, respondent's liability to reimburse American Bankers for claims paid on the credit accident and health insurance was limited to the amount of earned premiums it

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[8] When premiums have been paid for coverage to be provided in the future, they are deemed "unearned;" as time passes, a portion of the premium becomes "earned," according to any one of a number of methods of computation, until the coverage expires, at which time the entire premium has been "earned."

had received from American Bankers, or was carried over as a charge against premiums as they became earned in the future, and could not, by virtue of Articles I and V of said Treaty I (Pet. App. 26a and 29a-30a), ever exceed the total amount of payments made by American Bankers to respondent.

Pursuant to Article VI of Treaty I (Pet. App. 30a), respondent maintained all reserves required for the credit life insurance covered by the treaty (for which it had received from American Bankers all premiums at the outset, as written), and American Bankers owned, established and maintained all "unearned premiums, loss and other reserves as may be required by law" for the credit accident and health policies as to which American Bankers had retained the premiums until such time as they became "earned."

When respondent had qualified to write insurance directly in certain states in which Southern Discount did business, by 1962, it entered into a second treaty ("Treaty II") pursuant to which respondent, as the primary insurer, ceded to American Bankers eighty percent of its credit accident and health insurance (later sixty-five percent), but did not reinsure the credit life insurance. The reinsurance of credit accident and health insurance according to the terms of Treaty II was on an "as written," as opposed to an "as earned" basis, and respondent ceded to American Bankers all of the premiums on that portion of the insurance subject to the treaty at the time written, and American Bankers established the unearned premium reserves for said insurance which were required by law. Also, as provided by the laws of Arizona and Georgia, respondent took credit, for reserves held by American

Bankers, against the reserves which would otherwise have been required by virtue of its acting as direct writer for this insurance. There was no limitation to the liability which American Bankers assumed under this treaty; it was obligated to reimburse respondent in the full amount of claims paid by respondent to its policyholders. There was, furthermore, an experience refund provision in the treaty, which provided that if the reinsured business was profitable American Bankers would refund to respondent the profit resulting from premiums received in excess of claims and expenses for commissions incurred, after an allocation of three percent of the gross premium to American Bankers.

The applicable Arizona law concerning reserves is found in §20-506 of the Arizona insurance code:

> A. With reference to insurance against loss or damage to property, except as provided in §20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§20-508 and 20-510 [not in point here], and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.
>
> B. The director may require that such reserves be equal to the unearned portions of the gross premiums in force *after deducting reinsurance in solvent insurers* as computed on each respective risk from the policy's date of issue. [emphasis added].

Georgia Code Ann. §56-906 contains a substantially identical provision.

The Arizona law imposes its requirement for unearned premium reserves on insurers as policies come in force, and provides a credit for insurance ceded to a solvent reinsurer, against this reserve requirement.

Thus under Arizona law respondent had no liability for reserves under Treaty I, since as to respondent said reinsurance was not in force until the premiums had become earned, and under Treaty II respondent received full credit for reinsurance ceded to American Bankers, and was required to maintain no unearned premium reserves on the ceded portion.

The Government argues, however, that in view of the definition of assets in the Arizona and Georgia insurance laws,[9] an insurance company is required to establish reserves upon its assumption of the risk without regard to its actual receipt of the corresponding premiums. The Government's reliance on state statutes defining assets is misplaced. The purpose of defining assets (and liabilities) is related to determining the financial condition of a company and insuring that company's solvency. Contrary to the Government's assertion, the statutory definition of assets is not broadly drawn; rather, it is drawn in restrictive terms to insure that an insurance company does not overstate its assets.[10]

The specific sections of the Arizona and Georgia insurance laws defining assets neither require, nor permit, respondent to include in its assets the unearned premiums held by American Bankers. Assets "in the course of collection . . . not more than three months past due," Ga. Code Ann. §56-901(6) and Ariz. Rev. Stat. Ann. §20-501(5), cannot apply to the unearned premiums held by American Bankers nor to the earned

[9] Ariz. Rev. Stat. Ann. §20-501; Ga. Code Ann. §56-901.

[10] Thus, Ga. Code Ann. §56-901 states:

> In any determination of the financial condition of an insurer, there shall be *allowed* as assets *only such assets* as are owned by the insurer and which consist of . . . ." (emphasis added).

premiums to which respondent had a contractual right, since respondent had no right to the *unearned premiums*, and the *earned premiums* were not then due. Similarly, the definition of assets as "amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty," Ga. Code Ann. §56-901(10) and Ariz. Rev. Stat. Ann. §20-501(9), is inapplicable since the earned premiums were not withheld from respondent, and the unearned premiums did not constitute an amount receivable by respondent. As was held by the court below,

> [Those] sections . . . refer to amounts already due and unpaid. The definition of assets . . . refers to items in the possession of the taxpayer or to which the taxpayer has an enforceable claim. Without including the unearned premium in taxpayer's assets, there can be no unearned premium reserve charged against that item [Pet. App. 83a].

The Government also refers to Ga. Code Ann. §56-901(8) and Ariz. Rev. Stat. Ann. §20-501(7), defining assets to include "notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon." This provision has no application to the unearned premiums held by American Bankers or the earned premiums to which respondent had a contractual right. The asset is clearly allowable only if there is an unearned premium reserve maintained by the party claiming the asset. The Government turns the statute around, arguing that since there is an asset, therefore, there must be an unearned premium reserve. But even assuming that respondent's

contractual right to earned premiums constituted a "note or like written obligation," respondent's right was to earned premiums only, and, accordingly, respondent would not have established an unearned premium reserve therefor. Unearned premiums do not automatically become earned; if the insurance is cancelled by the policyholder, the unearned portion must be returned, and will never become earned.

The fallacy in the Government's argument is its assumption that American Bankers, like a bank, merely held the unearned premiums. In fact, American Bankers not only held the unearned premiums, it had a contractual right to them and received the investment income therefrom. Respondent had a right to the premiums as and if they became earned; it had no right to the unearned premiums, and under the terms of the applicable Arizona and Georgia insurance laws, was not required to maintain reserves for these unearned premiums.

The Court of Appeals for the Seventh Circuit in *Economy Finance Corp. v. United States*, 501 F.2d 466, 478 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), *rehearing denied*, 421 U.S. 922 (1975), Motion for Leave to File a Second and Untimely Petition for Rehearing, *pending*, No. 74-701, likened the reserves held by the reinsurer in that case to bank deposits, but the facts in *Economy* are clearly distinguishable from the facts in the instant case. In *Economy*, the court found that the unrelated reinsurer invested said reserve funds in debentures of the finance company and paid over the interest from these debentures, as additional commissions, to a family owned insurance agency comprised of the principal stockholders of the finance company. Unlike American Bankers in the instant case, that unrelated reinsurer merely served as a conduit for the return of said reserves to the related group of companies, and did not even retain the investment income generated thereby. Such facts would clearly indicate that this was indeed more akin to a mere deposit arrangement and is totally distinguishable from the facts in the present case, where the Court of Claims found that respondent did not obtain or use the unearned premiums, "nor were said unearned premiums credited, set apart, or made available" to respondent (Finding of Fact 43, Pet. App. 107a).

Apparently recognizing that respondent was not required by the express language of the Arizona and Georgia insurance laws to maintain reserves on unearned premiums held by American Bankers, the Government asserts that both the Arizona and Georgia insurance laws are based upon the proposition that insurance reserves should follow the insurance risk. The Government's argument proceeds that, since respondent allegedly bore the ultimate insurance risk on the accident and health policies, respondent was required by state law to establish the reserves therefor, even though respondent did not hold the unearned premiums. The Government bases its argument upon its interpretation of the requirements of Arizona and Georgia insurance laws. Insofar as the Government relies on the Arizona and Georgia insurance laws' definitions of assets discussed above, respondent submits that there is absolutely nothing contained therein which supports the theory that insurance reserves follow the insurance risk. The provisions of the Arizona and Georgia insurance statutes which are relevant to a determination of the respective states' unearned premium reserve re-

quirements[11] are not even cited by the Government, and in fact furnish no support for its theory. Nor has the Government been able to cite any judicial or administrative decision supporting its theory.

If there is any doubt as to the construction to be placed upon the Georgia and Arizona insurance laws respecting reserves for unearned premiums, the actions of the respective Georgia and Arizona insurance regulatory agencies are conclusive evidence that respondent was not required by state law to maintain reserves for the unearned premiums held by American Bankers. In the present situation, both the Arizona and Georgia insurance laws provided for enforcement of these laws by the state regulatory agencies. Under Ariz. Rev. Stat. Ann. §20-152 the director of insurance was empowered to certify the facts of any violation to the attorney general for enjoining the violation. Similarly, in Georgia, the Commissioner of Insurance had authority under Ga. Code Ann. §56-214 to institute legal proceedings for the enforcement of any provision of the Act. As found by the Court of Claims, "for the years in question, none of these actions were taken by either of the state offices in charge" (Pet. App. 88a).

In its holding below the Court of Claims emphasized the generally accepted principle that where a statute is ambiguous or doubtful, and in the absence of judicial authority to the contrary, it is generally accepted that the uniform and consistent interpretation of that statute by the regulatory body charged with administration thereof is entitled to great weight (Pet. App. 88a). This principle was clearly set forth in *Salt Lake County v.*

[11] Ariz. Rev. Stat. Ann. §20-506; Ga. Code Ann. §56-906.

Kennecott Copper Corp., 163 F.2d 484, 489 (10th Cir. 1947), *cert. denied*, 333 U.S. 832 (1948), where the Court of Appeals adopted a state administrative agency's interpretation of an ambiguous state statute. *See also Traveler's Indemnity Co. v. Wells*, 316 F.2d 770, 773 (4th Cir. 1963).

This principle has been approved by this Court, on numerous occasions, in cases involving interpretation of Federal statutes by Federal administrative agencies. *Norwegian Nitrogen Products Co. v. United States*, 288 U.S. 294, 358 (1933); *Trafficante v. Metropolitan Life Ins. Co.*, 409 U.S. 205, 210 (1972); *Griggs v. Duke Power Co.*, 401 U.S. 424, 433-34 (1971); and *Robertson v. Dowling*, 127 U.S. 607, 613 (1888). Both the Georgia and Arizona Supreme Courts would apply the same principle. *See e.g., Chee Lee v. Superior Court*, 81 Ariz. 142, 302 P.2d 529 (1956) and *Thompson v. Eastern Air Lines, Inc.*, 200 Ga. 216, 36 S.E.2d 675 (1946). The cases cited by the Government, *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967); *King v. Order of United Commercial Travelers of America*, 333 U.S. 153 (1948); and *West v. A. T. & T. Co.*, 311 U.S. 223 (1940), although involving a somewhat different issue, are consistent with the rule established by the decision in *Salt Lake County v. Kennecott Copper Corp., supra*, and further support the conclusion that the actions of the Arizona and Georgia insurance agencies are determinative in this case as to the reserve requirements of the state insurance laws.

The actual rule established by the cases cited by the Government is that "an intermediate appellate state court * * * is a datum for ascertaining State law which is not lightly to be disregarded by a federal court *unless*

it is convinced by other persuasive data that the highest court of the state would decide otherwise." Estate of Bosch, supra, at 465. The Government has failed to indicate that "other persuasive data" exists which would convince a Federal court that the highest courts of the states of Arizona and Georgia would have adopted a construction of the Arizona and Georgia insurance laws different from that applied by the regulatory agencies in question. The Government has failed to cite a single state court decision or administrative rule or regulation supporting its construction of the Arizona or Georgia insurance laws. The very absence of any Arizona or Georgia state court decisions in this area demonstrates the importance of administrative agency interpretations in interpreting and enforcing state law provisions with respect to required reserves. The decision in *King v. Order of United Commercial Travelers of America, supra,* illustrates the rule stated above. In that case, this Court concluded that an intermediate state court decision was not binding on Federal courts because decisions of that intermediate state court were not binding on any other state courts. But in the present case, the interpretation of the insurance laws by the administrative agencies charged with their enforcement would be accorded great weight by the highest courts of the states of Arizona and Georgia. *See e.g., Chee Lee v. Superior Court, supra* at 33, and *Thompson v. Eastern Air Lines, Inc., supra* at 33.

The Government suggests that the uniformly consistent approval of respondent's and American Bankers' method of handling the unearned premium reserves by the Georgia and Arizona administrative agencies should be of no import, in the case of Georgia, because the chief Georgia insurance examiner testified that the agency's

action was done "unwittingly" and contrary to state policy. Similarly, in the case of Arizona, the Arizona examiner testified that respondent should have been required to maintain the reserves under Treaty II, but had been permitted to exclude the reserves because it was the first time that the Arizona Insurance Commissioner had encountered that type of arrangement. *See* discussion, *supra* at 7, note 1.

The Georgia examiner conceded that he was not familiar with the type of reinsurance treaties in question (A. 235-36 and 259-60) and was confused about the requirement of statutory law. Therefore his opinion concerning administrative practice is entitled to no weight. In fact, it is apparent that the chief examiner confused the reinsurance treaties in question with surplus aid contracts, which they plainly are not.[12] The Georgia examiner was not even employed by the Georgia Insurance Department during the years

[12] The Government contended in the court below that the reinsurance treaties in question were "surplus aid contracts," relying upon excerpts from the National Association of Insurance Commissioners, Examiners Handbook (3rd rev. ed. 1970) and testimony of the Arizona and Georgia examiners. (The Examiners Handbook was not admitted as evidence in this case because there was no evidence demonstrating that the Georgia or Arizona insurance departments used the Handbook for the tax years in question.) The surplus aid contracts referred to by the Government do not remotely resemble respondent's Treaty II, particularly in the one element which constitutes "surplus aid." That element is the existence of a "tentative" or "contingent" commission, paid at the outset to the ceding company but subject to repayment by the ceding company to the reinsurer in the event losses suffered by the reinsurer exceed an agreed-upon amount. This is the heart of the concept of illegitimate "surplus aid"—the existence of an amount of money credited initially to the ceding company and claimed by it as surplus capital, but which may be recalled by the reinsurer. It is obvious that the approach of the National Association of Insurance Commissioners, in refusing credit to the ceding company for a reserve held by the reinsurer on *this portion* (and this portion only) of the

in issue in this case and had no involvement in the examination of respondent. Since the reinsurance treaties in question were the first of this type that the Georgia examiner had seen, it is obvious that he was not qualified to testify as to what the policy of the Georgia Insurance Commissioner would be or should have been with respect to the reinsurance treaties in question.

The Arizona examiner's testimony is rendered meaningless by his confusion of these treaties with those

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total reserves required, has no application to respondent, which neither received nor took credit for any such "tentative commissions." Repondent's surplus could not have been affected by the negative carry-forward provision of the treaty which the Government finds so objectionable, since there was no requirement that respondent ever repay the negative amount out of claimed surplus (or any other source); rather, the carry-forward could only be set off against future payments due to respondent, and then only for a limited period of time. It should be noted that the reserve required on the "tentative commissions," if any, must be maintained by the party to the contract (the ceding company) who in fact *holds the premium dollars* on this portion, as respondent contends is the proper treatment. The difference between the "surplus aid contract" and respondent's Treaty II was carefully depicted on Plaintiff's Exhibit 27: "Comparison of Agreement Types" (A. 404).

Respondent received an experience refund from American Bankers, based on the profitability of the business ceded. This type of arrangement is described in the portion of the Handbook directly following the description of "surplus aid contracts" entitled "Ordinary 'Sliding Scale' Contracts." The first portion of that description reads thus:

> A large proportion of reinsurance business is written on a "sliding scale" or "profit commission" basis, so that if the ceded business is profitable, the ceding company will receive additional commissions from the reinsurer. There is no criticism of this provision, with the understanding no credit shall be taken for such contingent commission until the loss ratio has actually been developed and the additional commission, if any, has thus been earned.

As illustrated in Exhibit 27, no credit for surplus was taken by respondent for the experience refund, or additional commission, until it had in fact been earned.

which are known as surplus aid contracts (A. 265 and 269), but more importantly, whatever the examiner's views, they were specifically rejected by the Arizona Insurance Commissioner (A. 272-73).

The Government's reliance upon the testimony of the Arizona and Georgia insurance examiners is totally misplaced, since the fact remains that the formal and official acts of the administrative agencies of Georgia and Arizona were totally inconsistent with the testimony of those two witnesses. It is clear that the insurance departments of both states approved respondent's and American Bankers' method of handling the unearned premium reserves after thorough examinations and specific consideration of these treaties.

Respondent, for the tax years in question, was not required by state law, statutory or as administered, to maintain reserves on the unearned premiums in question. As Treas. Reg. §1.801-5 provides:

> (b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

The Government has failed to identify any express statutory provision, or any rule or regulation of the appropriate insurance department, which required respondent to maintain reserves on the unearned premiums

held by American Bankers, and accordingly no such reserves can be attributed to respondent for purposes of the definition of a "life insurance company" within the meaning of section 801(a) of the Code.

II. THE REINSURANCE TREATIES BETWEEN THE RESPONDENT AND AMERICAN BANKERS HAD APPRECIABLE ECONOMIC SUBSTANCE AND WERE ENTERED INTO FOR VALID BUSINESS PURPOSES.

The Government has argued in its brief that decisions of this Court involving assignment of income principles and lack of economic substance should be applicable to the case at bar. It is respectfully submitted that the cases relied upon do not support the Government's contentions and that the principles set forth in these cases should have no application to the case at bar.

A. Assignment of Income Principles Are Not Applicable to this Case.

The court below found as a fact that both reinsurance treaties between the respondent and American Bankers were entered into for valid business reasons by unrelated parties dealing at arms' length (Finding of Fact 21, Pet. App. 99a). Furthermore, the court found that, at all times, the unearned premiums and corresponding reserves in question were physically held and maintained by American Bankers, which received the investment income thereon and reported said reserves for purposes of state regulation as well as taxation (Finding of Fact 43, Pet. App. 107a). The court below also found, and the evidence is clear and uncontroverted to this effect, that the treatment of these reserves by the state insurance regulatory authorities of all the states

involved, with respect to both respondent and American Bankers, was entirely consistent with respondent's treatment of said reserves. Thus, based on these facts the question presented is whether a situation involving two unrelated parties dealing at arms' length, who enter into a business transaction for valid business purposes and who treat the transaction in a manner in accordance with state law and acceptable to state insurance regulatory authorities, can be said to be lacking in economic substance or reality so as to be disregarded for purposes of the income tax laws. Respondent submits that the cases cited by the Government dictate a negative response and that these cases do not support the Government's contentions.

Respondent recognizes that in cases dealing with closely related parties this Court has developed the doctrine that income will be taxed to the one who earns it, and that anticipatory assignments to shift that income to another party will be disregarded for tax purposes. However, that doctrine should not be applicable to the instant case because it deals solely with the taxation of *income* to a party other than the party which in fact receives the income. That is clearly not the question before this Court.[13]

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[13] The Government has suggested that the case of *Commissioner v. Hansen*, 360 U.S. 446 (1959), is at least analogous to the case at bar (Pet. Brief 57). The *Hansen* case dealt not with the question of ownership of assets or state regulation, but with a specific statute (Section 42 of the 1939 Code) pertaining to rules of accrual accounting. The question raised in *Hansen* was when income should be recognized by a taxpayer using the accrual method of accounting and is totally inapplicable to the question of whether assets such as unearned premiums (or the liability account for reserves), may be attributed from one to another unrelated taxpayer. In *Hansen* the Court found that the taxpayer had a fixed right to receive the income in question. Respondent finds the analogy of

The cases relied upon by the Government do not support the proposition that insurance reserves may be attributed or reallocated to parties not in possession thereof in the same manner that income may be. In *Lucas v. Earl*, 281 U.S. 111 (1930), it was held that the statute in question taxed salaries to those who earned them, and a husband who earned salaries and fees could not escape income taxation on them by entering into a contract vesting the salaries and fees in his wife. Similarly, in *Helvering v. Horst*, 311 U.S. 112 (1940), it was held that one could not escape tax by making a gift of detachable bond interest coupons in advance of the payment of interest; and in *Corliss v. Bowers*, 281 U.S. 376 (1930), it was held that when a donor retained control over trust property the donor remained taxable on the income although it was paid to the donee. In *United States v. Basye*, 410 U.S. 441 (1973), also cited by the Government, the partners of a medical partnership were held to have received compensation with respect to payments that were paid into a retirement trust for the benefit of the partners of the medical partnership pursuant to the terms of a written agreement. As this Court pointed out in the *Horst* case:

> Underlying the reasoning in cases like *Helvering v. Clifford*, 309 U.S. 331 (1940), is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also

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the *Hansen* case to the present case difficult to comprehend because in the instant case there is no question concerning the accrual of income, which is governed by specific statutory provisions inapplicable to this case. Furthermore, even as to respondent's right to these assets, respondent had no fixed right to receive the unearned premiums, which were subject, at any time prior to becoming earned, to be returned to the policyholder upon cancellation of the policy, as, for example, when the customer's debt was prepaid.

> controls the disposition of that *which he could have received himself* and diverts the payment from himself to others as the means of procuring the satisfaction of his wants . . . whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. 311 U.S. at 116-17 [emphasis added].

It is submitted that the Government's reliance on these cases and others similar to them is entirely misplaced because in the present case we have two unrelated parties, each of which was regulated by state law; each performed its respective functions, which it was licensed to perform, pursuant to reinsurance treaties which provided for independent consideration for the responsibilities of each thereunder. Neither party sought to "vest" income *or* reserves in another in a manner inconsistent with its responsibilities under state law or the treaties, but, quite to the contrary, each party conducted its business affairs and maintained its financial accounts completely in accordance with state law. These circumstances do not warrant the same conclusions or the adoption of a rationale similar to that which was followed in the *Horst* case. In *Horst* the Court raised the question "whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment." 311 U.S. at 116. In answering its question the Court cited *Burnet v. Wells*, 289 U.S. 670 (1933) and held that the exercise of the power "to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it." 311 U.S. at 118.

One need only point to the decision of this Court in *Commissioner v. First Security Bank*, 405 U.S. 394 (1972) as authority for the inapplicability of the *Lucas* and *Horst* cases, and others cited, to the instant case. In *First Security Bank* this Court held "that the Commissioner could not properly allocate any income to one of a controlled group of corporations under 26 U.S.C. §482 where that corporation could not have received that income as a matter of law." *United States v. Basye*, 410 U.S. at 454, n. 13 (1973). The facts in *First Security Bank* involved a business plan substantially identical to that which as was utilized in the cases pending in the present consolidated cases, wherein a bank holding company organized an Arizona life insurance company for the purpose of reinsuring credit insurance written by other unrelated insurance companies including, coincidentally, American Bankers, with respect to customers of a bank subsidiary of the holding company. In *First Security Bank* the Government sought to reallocate the income of the life insurance company to the bank subsidiary pursuant to the authority of section 482 of the Internal Revenue Code. This Court was faced with resolving conflicting decisions in *Local Finance Corp. v. Commissioner*, 48 T.C. 773 (1969), *aff'd*, 407 F.2d 629 (7th Cir. 1969), *cert. denied* 396 U.S. 956 (1969) and the decision of the lower court in *First Security Bank*, 26 T.C.M. 1320, *rev'd*, 436 F.2d 1192 (10th Cir. 1971). In both cases the Tax Court had held against the taxpayer, basing its decisions on the rationale developed in *Lucas v. Earl, supra*, and *Helvering v. Horst, supra*. In the *First Security Bank* case, the Court of Appeals for the Tenth Circuit and this Court differed with the conclusions of the Tax Court. The Tenth Circuit decision stated:

> Generation of income differs from assignment of income. It is fundamental that the taxpayer cannot assign a portion of his income in order to avoid tax liability on it. . . . Also the power to dispose of income is the equivalent of ownership. . . . These principles are grounded on rights in or flowing from income. 436 F.2d at 1197.

In affirming the Tenth Circuit this Court stated:

> We know of no decision of this Court wherein a person has been found to have taxable income which he did not receive and that he was prohibited from receiving.
>
> . . . [T]he assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another. 405 U.S. at 403-04.

Since the Commissioner would not have had the power to assign income under the general principles of section 61 of the Internal Revenue Code, *First Security Bank* denied the Commissioner the power to allocate the income under section 482. In the present consolidated cases the Commissioner seeks again to apply the same theories that were rejected by this Court in *First Security Bank* and the same conclusion should be reached in these cases.

Respondent respectfully submits that assignment of income principles are not applicable to situations involving unrelated parties dealing at arms' length in transactions that are consistent in all respects with state law and, in addition, with general accounting and actuarial principles applicable to the particular industry involved.

B. The Reinsurance Transactions Between Respondent and American Bankers Possessed Appreciable Economic Effect.

In asserting that the reinsurance transactions between the respondent and American Bankers lacked economic substance and are therefore to be ignored for Federal tax purposes, the Government has relied on a legal theory and cases which, it is submitted, are not applicable to the case before this Court. The case of *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935), is the touchstone for the Government's argument, but respondent believes that the doctrine of the *Gregory* case, as further developed by subsequent cases, is inapplicable to the case at bar. In the *Gregory* case, a corporation and its sole stockholder attempted to accomplish through the form of a statutory corporate reorganization a transaction which had no other purpose apart from tax motives. Judge Hand speaking for the Court of Appeals for the Second Circuit held that the transaction did not meet the test of a reorganization because "the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham. . . ." 69 F.2d at 811. This Court, while recognizing the legal right of a taxpayer to decrease or avoid taxes altogether by means which the law permits, affirmed the Second Circuit's decision and found that the reorganization was but "an operation having no business or corporate purposes—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character. . . ." 293 U.S. at 469. Thus, this Court held that the sole object was to consummate a preconceived plan to transfer to the sole stockholder shares of stock in another corporation and not to reorganize a business,

and that this effort should not be recognized for Federal income tax purposes.

In analyzing this Court's decision in *Gregory* and the subsequent cases of *Griffiths v. Helvering*, 308 U.S. 355 (1939); *Higgins v. Smith*, 308 U.S. 473 (1940); and *Bazley v. Commissioner*, 331 U.S. 737 (1947), Judge Hand concluded in the context of a later case that these cases in no way intimate that a transaction should be disregarded even where a taxpayer's only motive is to minimize taxes, or to reduce taxes; but, rather, the doctrine of those decisions "covers *only those transactions that do not appreciably change the taxpayer's financial position*, either beneficially or detrimentally." *Gilbert v. Commissioner*, 248 F.2d 399, 410-12 (2d Cir. 1957), (dissenting opinion) (emphasis added). Judge Hand further suggested that an appreciable change in a taxpayer's financial position should be the determining test, and not the fact of whether the transaction "has substantial economic reality" or "is a 'sham' or a 'masquerade' or 'depends upon the substance of the transaction.' " *Gilbert v. Commissioner, supra* at 411. Judge Hand stated:

> If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.

The test proposed by Judge Hand in his dissent in the *Gilbert* case was recognized with approval in *Knetsch v. United States*, 364 U.S. 361, 366 (1960). There the taxpayer entered into an annuity transaction with an unrelated insurance company pursuant to which the taxpayer claimed large interest deductions. This Court

held that the taxpayer's transactions with the insurance company did not "appreciably affect his beneficial interest except to reduce his tax." *Id.* In *Knetsch* this Court further stated "it was patent there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." *Id.*[14]

Based on the test of appreciable change in the taxpayer's financial position as developed by the *Knetsch* case and the *Gilbert* dissent, it would seem that a business transaction must be recognized for tax purposes if the transaction is treated consistently for material *non-tax* purposes. *See,* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L.J. 440, 462-64 (1968). Conversely, a transaction does not appreciably change the taxpayer's financial position either beneficially or detrimentally when it involves no part of the conduct of the business of the participants. The result, therefore, should be that if the transaction in question has appreciable non-tax consequences then consistent treatment must be accorded for tax purposes. This test is consistent with the decision in *Knetsch,* where this Court concluded that the transaction should be ignored for tax purposes since it had no economic purpose apart from tax savings and, indeed, except for taxes, resulted in a substantial economic loss.

The "appreciable effect" test as developed by Judge Hand in his dissenting opinion in *Gilbert, supra,* and by

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[14] The dissenting opinion in *Knetsch* would have recognized the annuity transaction for tax purposes even if only to achieve a tax deduction "as long as the transaction itself is not hocus-pocus," and pointed out that these transactions were real and legitimate in the insurance world, emphasizing, as respondent does elsewhere in this brief, the importance of regulatory action by authorized bodies concerning commercial transactions.

this Court in *Knetsch, supra,* is even more applicable to a business transaction in situations where, as in the case at bar, the non-tax consequences include a specific recognition of the transaction by state regulatory authorities with respect to both parties to the transaction. The principle has long been recognized that state law controls "when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." *See, Burnet v. Harmel,* 287 U.S. 103, 110 (1932). Thus, in a situation such as the case at bar, where Federal tax law has clearly looked to the respective state insurance laws and to the state regulatory agencies, the fact that the entire reinsurance transaction was accorded the treatment for state regulatory purposes which the parties themselves gave it should be given considerable weight and, it is submitted, should constitute conclusive and binding authority in determining whether the "appreciable effect" test is met for purposes of applying the Federal tax laws.

In the present case the entire thrust of the Government's position with respect to the economic substance argument is contrary to the *Knetsch* and *Gilbert* dissent test, since the Government argues that the transaction should not be recognized for tax purposes notwithstanding that it was so recognized for non-tax purposes and particularly for state regulatory purposes. The findings of the court below clearly support the respondent's argument that there were "appreciable" non-tax consequences flowing from the transaction.[15] Since the

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[15] It should also be noted that there was a recognition of business purpose by this Court in the *First Security Bank* case, *supra* at 42, in a situation involving similar transactions.

transaction had a business purpose for each of the unrelated participants, which was recognized by the appropriate regulatory authorities, the following language of Judge Hand has particular application:

> In construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation. *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949).

Applying the "appreciable effect" test to the instant case, both respondent and American Bankers were in a position, as a result of the reinsurance treaties, by which their respective financial positions could be affected, either beneficially or detrimentally. American Bankers assumed responsibility for paying for claims for which it received a consideration and respondent relieved itself from obligations to establish and maintain substantial reserves which would have adversely affected its relative capital and surplus position. Respondent furthermore gained the advantage of deferring or spreading out the risk from potential claims. It is respectfully submitted, therefore, that the 'appreciable effect" test clearly has been met in the present case.

C. Tax Minimization Motives Are to Be Disregarded in Judging the Reinsurance Transaction.

Respondent readily concedes that an aspect of the reinsurance treaties between respondent and American Bankers was the qualification of respondent as a life insurance company for purposes of deferring a portion of its taxes. However, the decisions of this Court are

well settled that "a taxpayer's motive is irrelevant in determining his liability." *Loewi v. Ryan*, 229 F.2d 627, 629 (2d Cir. 1956). In that case the court said:

> [W]e hold that the Act is to be interpreted against its own background, and in deciding how far it adopted all legal transactions that the state law may have covered, [referring to the transaction in *Gregory v. Helvering*] it was proper to exclude those that had no other result than to evade taxation. The purpose of the Act was to exempt from tax only such legal transactions as arose out of an enterprise or venture that had some other authentic object of its own, and were neither alien and hostile to the raising of revenue, nor designed to effect no change in legal interests except to defeat a tax. *Id.* at 629.

In *Kraft Foods Company v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), the Court of Appeals for the Second Circuit reaffirmed its holding in the *Loewi* case and specifically raised the question "[a]ssuming, then, that the purpose of the transaction was to minimize taxes, should the transaction be disregarded because of its tax motivation?" *Id.* at 127. The Commissioner argued that such transactions should be disregarded if they have no purpose other than tax minimization. The Second Circuit rejected the Commissioner's argument and held:

> We do not think that these cases hold that tax minimization is an improper objective of corporate management; they hold that transactions, even though real, may be disregarded if they are sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact. *Id.* at 128.

Respondent's business purpose was not to evade or defeat a tax but to minimize its tax by legally permissible means while conducting its business in the most profitable manner legally allowable. To accomplish this respondent determined to enter into legal arrangements providing for reinsurance whereby an unrelated party would share the insurance risk, in consideration of an agreed upon amount and the right to earn income from the investment of its reserves.

It is respectfully submitted that the reinsurance transactions pursuant to Treaty I and Treaty II comply with the "appreciable effect" test as previously adopted by this Court and the Treaties should be recognized for tax purposes, and that respondent's motive to minimize its taxes by legally permissible means does not detract from the conclusion that the reinsurance treaties appreciably affected the financial positions of both respondent and American Bankers.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims in No. 75-1221 should be affirmed.

Respectfully submitted,

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October 1976

FOR ARGUMENT

Supreme Court, U. S.
FILED
DEC 1 1976
MICHAEL RODAK, JR., CLERK

Nos. 75-1221, 75-1260 and 75-1285

In the Supreme Court of the United States

OCTOBER TERM, 1976

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 75–1221

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

No. 75–1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

No. 75–1285

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. The central point of our submission in these cases, as set forth in our opening brief (pp. 37–41), is that

the term "unearned premiums" in Section 801(c)(2) (26 U.S.C.) refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims. Under the two types of reinsurance arrangements at issue, the taxpayer companies bore the risk of meeting claims with respect to the accident and health coverage.[1] Thus, the accident and health unearned premium reserves attributable to such coverage must be included in their "total reserves" under the statute, despite the temporary physical possession of the unearned premium dollars by other insurance companies which were parties to the arrangements.

[1] Respondent Penn Security (No. 75–1285) does not appear to challenge the fact that it assumed the accident and health insurance risks under the Treaty I-type arrangements involved in that case (see Br. 36–39). However, with respect to the same type of reinsurance treaty, Consumer Life (No. 75–1221) contends (Br. 4–5): (1) that it did not concede that it assumed the insurance risk; and (2) that the Court of Claims did not find that it had made such a concession. But the record shows that Consumer Life's counsel stated at trial that "ultimately way on out many, many months or years, 100 percent of the risk would be borne by Consumers. There's no question about that" (No. 75–1221—A. 131.) The Court of Claims therefore properly found that "[u]nder Treaty I, all life and A & H policies * * * were to be fully reinsured with plaintiff [Consumer Life] which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved" (No. 75–1221—Pet. App. B 70a).

Petitioner First Railroad (No. 75–1260) similarly denies (Br. 9–10) that its expert witness conceded that the Treaty II-type arrangement did not shift the insurance risk to the other company. But an examination of his testimony shows that he refused to state that the arrangement spread the risk of the loss except in the limited sense that the arrangement permitted the company to take on more business (see No. 75–1260—A. 123).

In response, the taxpayers have advanced contradictory, but equally unsound, arguments as to the meaning of the statutory term "unearned premiums" and the nature of an insurance reserve.

a. *No. 75–1221.* Respondent Consumer Life Insurance Company acknowledges the correctness of our statutory analysis that the term "unearned premiums" refers to the unearned premium reserve that represents a company's liability to meet claims. Nevertheless, it contends (Br. 20–21) that as a matter of state law and accounting practice, it was not required to establish a liability for an unearned premium reserve because it had no corresponding "unearned premium" asset. However, the language and structure of Section 801(c) demonstrate that state law requirements have no relevance in determining whether "unearned premiums" are includable in a company's total reserves under Section 801(c)(2).

Section 801(c) lists three types of reserves: "(1) life insurance reserves, (2) unearned premiums, and unpaid losses * * * not included in life insurance reserves, and (3) all other insurance reserves required by law." As in the case of the third category of "all other insurance reserves", the Code prescribes that the first category—"life insurance reserves"—must also be "required by law" in order to be taken into account for federal tax purposes. See Section 801(b)(2); Treasury Regulations, Section 1.801–4(a)(3) (26 C.F.R.). Section 1.801–5(b) further defines the phrase "required by law" as state statutory or regulatory law.

However, in marked contrast to the first and third categories of reserves set forth in Section 801(c), the statute does not employ the term "required by law" with respect to the second category of reserve—"unearned premiums." Congress therefore intended that the question of inclusion in "total reserves" of "unearned premiums"—the special type of reserve applicable only to casualty insurance—was to be determined without regard to state law. Indeed, in defining the term "unearned premiums," Treasury Regulations, Section 1.801–3(e) expressly provides that "[s]uch term includes all unearned premiums, *whether or not required by law*" (emphasis supplied). Thus, the only relevance of state law for purposes of Section 801(c)(2) is to confirm the proposition that the unearned premiums reserve for nonlife coverage must be attributed to the company that bears the insurance risk (see our opening brief, pp. 66–75).[2]

[2] As we demonstrate in our opening brief (pp. 66–75), the state statutes to which the taxpayers were subject required them to establish unearned premiums reserves for the accident and health coverage on which they assumed the risk. However, all three taxpayers argue that the state officials' failure to require them to establish such a reserve and those officials' acquiescence in the establishment of the reserve by the other companies show that the accident and health reserve was not a reserve "required by law" within the meaning of Section 801(c)(3) (see Consumer Life, Br. 25; First Railroad Br. 30–34; Penn Security Br. 31–36). In support of this contention, Penn Security cites (Br. 33) Treasury Regulations, Section 1.801–5(b). That Regulation provides that one of the elements of the term "required by law" is that the reserve be "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries."

But this Regulation only comes into play with respect to the third catch-all category of reserves under Section 801(c)(3)—"all other insurance reserves required by law." Thus, if, as we submit, the reserves in question are "unearned premiums" under Section 801(c)(2), the state officials' acceptance of the taxpayers' annual statements has no relevance. At all events, the history of Section 1.801–5(b) of the Regulation establishes that the quoted phrase was intended to permit insurance companies to compute "other" types of reserves on a more conservative basis than the minimum amounts required by the state reserve valuation statutes. The proposed regulations would have prescribed the minimum statutory valuation reserves as "required by law" (see 25 Fed. Reg. 7983, 7986). However, we are advised by the Department of the Treasury that it modified the Regulation to permit companies to compute their reserves on a more conservative basis after the insurance industry argued that the term "required by law" referred only to the type and not the amount of the reserve. Cf. *Lamana-Panno-Fallo I. Ins. Co.* v. *Commissioner*, 127 F. 2d 56, 58 (C.A. 5). Hence, the computational question addressed by the Regulation has no bearing on the reserve attribution issue presented in these cases.

[3] Respondent Penn Security relies (Br. 33) upon *State ex rel. American Central Ins. Co.* v. *Gehner*, 320 Mo. 901, 9 S.W. 2d 621, as authority for the proposition that it was not required by Mis-

At all events, as we have discussed in greater detail in our opening brief (pp. 69–72), there is no matching principle under the state statutes to which the taxpayers were subject in these cases that a reserve can only be established if there is a corresponding asset. To the contrary, state law contemplates the establishment of an unearned premium reserve upon assumption of the insurance risk even prior to the time that the right to receive the premiums becomes fixed.[3]

Finally, even assuming *arguendo* the existence of such a matching principle, the generally accepted accounting treatment of reinsurance, endorsed by a leading reinsurance text (Hammond, *Insurance Accounting Fire & Casualty* (2d ed. 1965)), requires the creation of a corresponding asset. Professor Hammond states that even if the issuing company in a reinsurance transaction such as the Treaty I-type arrangement withholds payment of the account under the provisions of the agreement "for an extended period," the accounting treatment on the reinsurer's books "is the same as any other premium transaction, except that the *Funds Held By or Deposited With Ceding Reinsurers* account is debited instead of *Agents' Balances or Uncollected Premiums* or *Cash.*" *Id.* at 142.[4]

souri law to establish a reserve for the accident and health coverage. But that state tax case deals with reserves with respect to uncollected premiums, which are in no way comparable to the premiums that were paid in advance by the policyholders and temporarily held by another company on behalf of Penn Security.

[4] Professor Hammond further states (p. 143) that "[w]hen the funds are withheld over an extended period, the contract may provide for the payment of interest on the money." Thus, the receipt of interest income is simply one of many elements of the economic arrangement between the ceding company and the reinsurer and should not control the question of attribution of the reserves for federal tax purposes. For example, a depositor's ownership of the funds in his checking account is hardly diminished by the fact that the account is non-interest bearing.

There is accordingly no basis to Consumer Life's (No. 75–1221—Br. 30) and Penn Security's proposed distinction (No. 75–1285—Br. 14) of their cases from *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending, No. 74–701, on the ground

Thus, the reinsurer is deemed to have received the premiums at the very outset of the arrangement and the ceding company's temporary physical possession of the premiums is ignored.[5]

that in *Economy Finance* the taxpayer received the interest income from the unearned premiums. Indeed, the Seventh Circuit in *Economy Finance* mentioned the interest income point in passing (see *id.* at 480) and properly declined to give it great weight.

Finally, the excerpt from Thompson, *Reinsurance*, p. 174 (4th ed. 1966), quoted by Penn Security (Br. 35, n. 15), does not contradict Professor Hammond's analysis. The statement in Thompson is made in the context of describing a special form of reinsurance known as excess loss reinsurance. Under excess loss reinsurance, the reinsurer assumes the risk of losses beyond a stated portion of gross premiums rather than a quota share of all losses. Thus, in such an arrangement, the ceding company continues to retain the reserve for unearned premiums because it remains liable on the risk represented by those premiums (see our opening brief, pp. 74–75, n. 30). Under excess loss reinsurance, the reinsurer may also establish a reserve based upon the premiums for the excess reinsured risk. Here, however, in the Treaty I-type arrangement, the taxpayers must establish a reserve equal to the gross unearned premiums because they assumed the entire risk under the policies.

[5] Consumer Life further argues (Br. 36, n. 12) that its Treaty II-type arrangement qualifies as a "sliding scale" agreement recognized by National Association of Insurance Commissioners, *Examiners Handbook*, pp. B16–B17 (1970 ed.) (see No. 75–1260—A. 235–236). But a "sliding scale" agreement, as described in the *Handbook*, is one that provides for a sharing of the profits of a favorable loss experience by means of a pro rata return of reinsurance premiums to the ceding company. Here, however, the reinsurer simply had a three percent stake in the premiums and did not share in either the losses or the profits.

Consumer Life (Br. 35) and First Railroad (Br. 11, 33) also argue that its Treaty II-type arrangements were not "surplus aid" agreements, as that term is described in the *Examiners Handbook*, pp. B14–B16 (No. 75–1260—A. 230–235). But the critical fact is not that the Treaty II-type arrangements served to aid the tax-

b. *No. 75–1260.* Petitioner First Railroad & Banking Company of Georgia adopts an opposite position. It urges (Br. 34–38) that the term "unearned premiums" in Section 801(c)(2) does not mean the unearned premium reserve but refers to the actual premium dollars. Thus, First Railroad claims that it had no "unearned premiums" because it temporarily relinquished those premium dollars to another company. In support of this argument, First Railroad relies upon Treasury Regulations, Section 1.801–3(e), which defines "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." In its view (Br. 36), the word "amounts" in the Regulations refers to the actual premium dollars.

But as we have pointed out in our opening brief (pp. 37–41), the phrase "unearned premiums" is the accepted insurance industry terminology for the unearned premium reserve, which traditionally represents the measure of the liability of a company to meet claims for short-term casualty coverage. See Hammond, *supra,* at p. 177. Since Section 801(c) deals with the single subject of insurance reserves, the term "unearned premiums" necessarily refers to the unearned premium reserve and not the premium dollars by which that reserve is measured.

Moreover, there is no basis to First Railroad's con-

payers' surplus in a particular manner but that there was no shifting of the risk to the other companies—"[t]he essential element of every true reinsurance contract." *Examiners Handbook*, p. B6 (No. 75–1260—A. 211).

tention that the word "amounts" in Section 1.801–3(e) of the Regulations refers to the actual premium dollars rather than to the amount of the unearned premium reserve. While the measuring rod of the unearned premium reserve is the unearned premiums, the unearned premiums are not conceptually equivalent to the reserve, which represents the company's liability to meet claims. Thus, the Regulation simply prescribes the method of computing the unearned premium reserve. Indeed, the word "amounts" cannot be read in isolation but must be considered in the context of the entire phrase which immediately follows, *viz.,* "amounts which shall cover the cost of carrying the insurance risk * * *." Since the taxpayers bore the insurance risk under each of the arrangements at issue, the "amounts" put to that risk are properly includable in their total reserves.[6]

[6] Respondent Penn Security (No. 75–1285) also relies upon Section 1.801–3(e) of the Regulations (Br. 24–27). However, it seizes on the term "paid in advance" and argues that it is not chargeable with the accident and health insurance reserves because it did not receive premiums "paid in advance" within the meaning of the Regulation.

To be sure, as Penn Security suggests (Br. 47), there can be no unearned premium reserve without premiums "paid in advance." But the Regulation does not provide that only the company receiving non-life premiums "paid in advance" must include the amount of such premiums in its earned premium reserve. If, as here, the company receiving such advance premiums reinsures the risk with another company, it is the reinsurer that bears "the cost of carrying the insurance risk for the period for which the premiums have been paid in advance" within the meaning of the Regulation. Here, it is undisputed that the taxpayer companies assumed the risk for the entire period of coverage for which the policyholders paid advance premiums (see also our opening brief, p. 59, n. 18).

c. *No. 75–1285.* Finally, respondent Penn Security Life Insurance Company argues (Br. 27–30) that the accident and health insurance reserves cannot be included in its "total reserves" because an insurance reserve is an actual sum of money and it did not "actually hold" such a fund within the meaning of Treasury Regulations, Section 1.801–5(a)(3). While insurance reserves have been sometimes described in a colloquial manner as funds set aside by the company, the authoritative insurance texts reject the characterization of reserves as assets; to the contrary, they define them as liabilities of the company to the policyholders. Thus, as stated in Dickerson, *Health Insurance,* pp. 526, 528 (Rev. ed. 1963): "Reserves are balance sheet accounts set up to reflect actual and potential liabilities under outstanding insurance contracts" and "Premium reserves represent liabilities for events which have not yet taken place." Similarly, Professor Hammond describes unearned premiums as "distinctive insurance company liabilities" and "*non ledger liabilities,* [which] are of major importance in establishing total liabilities * * *." Hammond, *supra,* at pp. 148, 177 (emphasis in original).[7] Accord: Mertens, *Law of Federal Income*

[7] See also Greider and Beadles, *Principles of Life Insurance*, pp. 68–69 (Rev. ed. 1972). While that text deals specifically with life insurance, the following description of reserve in that text is appropriate to all types of insurance reserves:

"It is doubtful that any other single life insurance concept lends itself more readily to misunderstanding than the idea of the policy reserve. The word 'reserve' is not to well chosen because it is used in several different ways in accounting and finance, where it may mean an asset, a reduction from an asset, or a liability. In life insurance, the policy reserves (the legal reserves) are liabilities. They are established as a way of determining or measuring the assets the company must maintain in order to be able to meet its future commitments under the policies it has issued.

The level-premium system contemplates the investment of that part of every net premium which exceeds the current cost of protection. It is frequently said that these amounts are 'held' and invested, to be used in the payment of claims in later years. However these amounts are not really held or invested as a separate fund and, indeed, the 'reserve' itself is not a fund—that is, it is not money, not assets of any kind. Thus, the reserve cannot be 'invested,' and it is not 'used' in later years when current premiums received by the company are not sufficient to meet current claims."

Taxation, § 44.26, n. 1 (1970 ed.), quoted at pp. 18–19 of Brief for Consumer Life.

Once it is understood that an insurance reserve is a liability and not a particular sum of money, it becomes readily apparent that the accident and health reserves were properly includable in the taxpayers' "total reserves" because they represent the liability of meeting claims of the policyholders. Since an insurance company does not physically set aside particular funds for reserves, the statement in Section 1.801–5(a)(3) of the Regulations that "the reserve must have been actually held during the taxable year for which the reserve is claimed" simply means that the company must in fact bear the liability with respect to insurance during the year for which it claims a reserve.[8]

[8] The correlation between an insurance reserve and the liability for the insurance risk is further shown by Treasury Regulations, Section 1.801–4(a)(3). While that Regulation also uses the word "held" in connection with life insurance, it states that "reserves held by the company with respect to the net value of risks reinsured in other solvent companies * * * shall be deducted from

2. Respondent Penn Security further argues (Br. 39–41) that the reinsurance arrangements in these cases are "substantially similar" to "modified coinsurance," as that term is defined by Section 820(b) of the Code. In its view, the treatment accorded to modified coinsurance by Section 820 is inconsistent with any congressional intention to attribute insurance reserves to the company that bears the risk.

But Section 820(b)(1) makes clear that the tax rules governing modified coinsurance are applicable only to life insurance and not to the short-term casualty coverage involved in these cases. Unlike reserves for short-term casualty insurance which are computed solely on the basis of the current actuarial risk in the form of a pro rata unearned premium, ordinary life insurance reserves are computed with an additional investment element. In the typical long-term premium life or noncancellable health insurance contract, the annual premiums received at the outset will exceed the cost of the insurance, but will be less than the cost of the insurance at the end of the term. Thus, there is an additional element in life insurance reserves that is computed on the assumption that the company will invest the excess of premiums over the cost of insurance at an assumed rate of interest in order to meet the obligation to pay bene-

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the company's life insurance reserves." The transfer of the risk through reinsurance need not occasion the physical transfer of specific "reserve funds," but simply requires the ceding company to reduce its reserve liabilities and the reinsurer to increase its reserve liabilities.

fits at the end of the term when the annual premiums are less than the cost of the insurance. See McLean, *Life Insurance,* pp. 111–114 (9th ed. 1962); *Massachusetts Protective Assn.* v. *United States,* 114 F. 2d 304, 308–209 (C.A. 1). Since it is this investment element that generally constitutes the bulk of life insurance reserves, it is the location of the corresponding assets held for investment by the insurance companies that determines which life insurer is chargeable with the life insurance reserve liability.

As the legislative history of Section 820 points out, modified coinsurance is a special form of life reinsurance where the reinsurer accepts the risk but the initial insurer retains the reserves and administers the investment of the assets corresponding to the reserves. However, the initial insurer pays over the gross investment income, less additions to reserves, to the reinsurer. The reinsurer, in turn, is obligated for all expenses incident to the coverage. See McGill, *Life Insurance,* pp. 438–440 (Rev. ed. 1967); Steffer, "Life and Health Reinsurance" in Gregg, *Life and Health Insurance Handbook,* p. 1037 (2d ed. 1964).

In these cases, Congress was concerned that the investment income might be taxed twice—once to the initial insurer as investment income, and again to the reinsurer as underwriting gain. In order to avoid that possibility, Section 820 permits the parties to such a reinsurance agreement to elect to treat the arrangement for tax purposes as if the reinsurer had issued the policy directly—as in a regular "coinsurance" transaction. Once the election is made, the re-

insurer is deemed to have received the premiums, incurred the expenses, and maintained the reserves with respect to the coverage.[9] See Section 820(c); S. Rep. No. 291, 86th Cong., 1st Sess., pp. 38–39 (1959).

It is therefore plain that the special life insurance reserve considerations that prompted Congress to enact Section 820 cannot be extrapolated into a generalized assertion of legislative intent with respect to the question of attribution of casualty insurance reserves in these cases. Unlike the situation addressed by that statutory solution with respect to modified coinsurance, reserves for the short-term cancellable [10]

[9] In the absence of such an election, the initial insurer is deemed to maintain the reserve. See Rev. Rul. 70–508, 1970–2 Cum. Bull. 136.

[10] Penn Security argues (Br. 45, n. 24) that the accident and health policies were "noncancellable life, health or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Because the Court of Claims held that the "unearned premiums" were not includable in Penn Security's "total reserves" under Section 801(c), it did not reach this additional contention. If the government prevails in the reserve attribution question before this Court, the case should be remanded to the Court of Claims to consider Penn Security's claim that the policies were noncancellable.

At all events, the legislative history of the predecessor of Section 801(a) clearly establishes that a "noncancellable" insurance policy is one which the company must renew at a specified premium and with respect to which a reserve (in addition to the pro rata unearned premium) must be established to cover the renewal obligation. See H.R. Rep. No. 2333, 77th Cong., 2d Sess., p. 109 (1942); see also Treasury Regulations, Sections 1.801–3(c) and 1.801–3(d). This additional reserve corresponds to the element in life insurance reserves calculated upon the assumption of the investment at interest of the level premium in excess of the current cost of insurance. See *Massachusetts Protective Assn.* v. *United States*, *supra*. Here, Penn Security did not give its policyholders a right to renew and did not maintain a renewal reserve. In the absence of such a reserve, the courts of appeals have uniformly held that such policies are not "noncancellable." See *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945, 951 (C.A. 4); *Group Life and Health Insurance Co.* v. *United States*, 434 F.2d 115 (C.A. 5), certiorari denied, 402 U.S. 944; *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480–482; *United Benefit Life Insurance Co.* v. *McCrory*, 414 F.2d 928 (C.A. 8), certiorari denied, 396 U.S. 1039.

coverage here are based only on the pro rata unearned premium and do not contain any element computed on the assumption of the company's investment of corresponding assets at a stated rate of interest. Since there are no investment assets corresponding to the short-term casualty insurance reserves involved here, these cases are not analogous to a modified coinsurance arrangement for life insurance contracts in the absence of an election under Section 820.[11]

3. Finally, First Railroad argues (Br. 16–19, 43–50) that the court of appeals improperly reversed the

[11] Penn Security further argues (Br. 42–45) that if the Court agrees with our submission that its accident and health reserves are included in its "total reserves," they should be included only on a net basis exclusive of loading costs. As in the case of Penn Security's argument that the policies were "noncancellable" (see n. 10, *supra*), the Court of Claims did not reach this contention. However, the appellate cases have thus far uniformly rejected Penn Security's position. See *Superior Life Insurance Co.* v. *United States*, *supra*, 462 F.2d at 951; *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 482–483. Moreover, Penn Security's expert witness testified that the general practice is to establish such reserves on a gross basis (see No. 75–1285—A. 203, 222–223). Accord: National Association of Insurance Commissioners, *Examiners Handbook*, p. B13 (1970 ed.) (No. 75—1260–A. 228).

district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P., Rule 52(a) protected the district court's finding that "there were substantial non-tax purposes for entering into the [Treaty II-type] arrangement" (No. 75–1260—Pet. App. B 14a). In the district court's view, the arrangement permitted Georgia Life to reduce its ratio of net written premiums to surplus so as to permit it to increase the volume of its credit accident and health business (No. 75–1260—Pet. App. B 14–15a).

But the court of appeals did not dispute the district court's finding in this respect. It was therefore not bound by the "clearly erroneous" rule of Rule 52(a). Rather, the court of appeals concluded, as a matter of law, that the proper test to be applied in determining whether the arrangement was reinsurance termed on whether or not there was a shift of the insurance risk on the underlying policies to Georgia Insurance. Since Georgia Insurance "did not bear any risks except the outside possibility of insolvency of [Georgia Life]," the court of appeals properly held that "there was no substance to the agreement as reinsurance" (Pet. App. A 4a–5a). Indeed, the decision of the court of appeals is buttressed by the district court's acknowledgement that "the risk of loss upon Georgia Insurance was, in actuality, remote" (Pet. App. B 14a).[12]

[12] The only risk Georgia Insurance actually assumed under the agreement was that claims on the ceded coverage would exceed 96 percent of the premiums, a figure more than four times the average claims experience. Indeed, even in that unlikely event, Georgia Insurance could recover such excess losses out of future premiums (Pet. App. B 14a).

CONCLUSION

For the reasons stated above and in our opening brief, the judgments of the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*) should be reversed, and the judgment of the court of appeals in No. 75–1260 (*First Railroad*) should be affirmed.

Respectfully submitted.

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DECEMBER 1976.

U.S. GOVERNMENT PRINTING OFFICE: 1976

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